ECONOMIC DEVELOPMENT WITH STABILITY

A Report to the Government of India
by
A Mission of the International Monetary Fund

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GOVERNMENT OF INDIA

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FOREWORD

This report has been presented to the Government of India by a Mission of the International Monetary Fund which visited this country during January-March, 1953, for a study of the economic and financial situation and for an assessment of the country's resources in relation to the implementation of the Five Year Plan. The Mission was headed by Mr. E. M. Bernstein, Director, Department of Research of International Monetary Fund and included Mr. Richard Goode, Mr. Morris Freidberg and Mr. I. G. Patel who are the Fund's technical advisers on fiscal and monetary problems. During its stay in India, the Mission had discussions with the various Ministries of the Government of India, the Reserve Bank of India, professional economists and representatives of Industry, Finance and Banking.

2. It is usual for the International Monetary Fund to send their staff to various countries for a local study of its problems so as to keep the Fund informed of the economic problems and the monetary and fiscal policies of the member governments. The Government of India welcomed the opportunity provided by the visit of such experts from an international institution for obtaining an independent view of the fiscal, monetary and economic policies and the progress of the Five Year Plan. While the views expressed in the report are entirely those of the Mission and the Government of India are not committed to them, they will take them into consideration in the framing of their future policies, within the framework of the social and economic objectives set forth in the Five Year Plan. The

296 M of F—1

report of the Mission will be of interest to business, financial and economic circles in the country as much as to Government.

Dated New Delhi,
the 30th January 1954.

K. G. AMBEGAOKAR,
Secretary to the Government of India,
Department of Economic Affairs,
Ministry of Finance.

CONTENTS

1. OBJECTIVES OF ECONOMIC POLICY

The basic economic problem of India is the widespread poverty of its people. The well-being of the people of India depends on the solution of this problem within the framework of its political system. In the long run the confidence of the people in their own economic, social, and political institutions will be determined more by the success of the Government in dealing with the problem of poverty than by any other single factor.

While the Five-Year Plan occupies the central position as the means through which the Government of India proposes to deal with the basic economic problem, it must be implemented by many specific economic and social measures. It is of the utmost importance that the measures taken in various fields should not only contribute to the fulfilment of the Five-Year plan but that they should form part of a consistent economic and social policy. The test of any measure must be a two-fold one: first, whether it will avoid deterioration in the present standard of living of the lower income groups; second, whether it will encourage a steady growth in production that will make possible a rising standard of living in the future.

1. Standard of Living

The standard of living of the people of India is among the lowest in the world. There is evidence that this standard of living has deteriorated somewhat since the pre-war period. In a country in which the greater part of the consumption of the poor consists of food grains and cloth, the amount of these goods consumed *per capita* may be regarded as a reliable indication of changes in the standard of living. The information that is available seems to indicate that the *per capita* consumption of food grains and of cloth is lower now than in the 1930's. The consumption of other goods and services may be somewhat higher than in the past, but this cannot be regarded as offsetting the decline in the *per capita* consumption of the basic necessities.

The standard of living of the lower income groups leaves almost no margin for reducing their consumption without impairing their health and efficiency. It may even be that a moderate increase in consumption at this time would enable the people to put forth in greater degree the effort necessary to carry out the Five-Year Plan. In any event, it is difficult to believe that a further reduction in the consumption of the lower income groups,

even for the purpose of providing resources for the Five-Year Plan, would be consistent with the broad social and economic objectives of the Government of India or would contribute in a constructive way to the success of the Five-Year Plan. Investment in the health, strength, and will of the people is as important to the economic progress of India as investment in plant and equipment.

Although a reduction in the consumption of the lower income groups must be avoided, this does not mean that no resources can be transferred from consumption to investment for the purpose of carrying out the Five-Year Plan. There are many persons with incomes above a tolerable standard of living and a much smaller number with very good incomes. Some reduction in the consumption of these income groups may be necessary for a time, although this will impose a burden on many people of modest means. For this reason, it is important that measures taken to secure resources for the Five-Year Plan should be not only effective but also equitable. The Five-Year Plan is not intended to provide windfall gains for any group; its one purpose is to increase the production and real income of the entire economy.

To protect the present standard of living of the lower income groups, it is necessary to avoid inflation. Any considerable rise in prices, particularly in the prices of food grains, will inevitably make it difficult for large numbers of people to maintain their present consumption of essential goods. Furthermore, inflation will result in an inequitable shift in incomes, with windfall profits to entrepreneurs and arbitrary losses to those who cannot defend their shrinking real incomes. The large rise in prices that has taken place between 1940 and the present has been especially burdensome to fixed income recipients, including civil servants, school teachers, and university instructors, and even salaried persons in private employment. No justification can be put forward for the more or less arbitrary further reduction of fixed incomes that would be imposed by an inflation associated with the Five-Year Plan.

2. Economic and Social Progress

India has faced enormous economic difficulties arising from the disruption of war and partition. It has come through these difficulties with an economy that is reasonably stable and it has begun to regain the ground that was lost in the past. The progress has been slow, too slow, and must now be accelerated. The minimum objective to be attained in the course of the Five-Year Plan is to restore the economy of India to its pre-war position. In

fact, it is necessary to go much further and provide the means by which production can be substantially increased and with it the level of consumption. Economic and social progress must be an objective of economic policy no less important than the protection of the present standard of living of the lower income groups.

The process of economic development is exceptionally complex. It involves much more than the provision of capital equipment. It requires a social attitude receptive to new fields and new methods of production, institutional arrangements that encourage enterprise and investment, and technical and managerial skills that make new methods of production effective. And it requires a healthy and well-trained labour force that can adapt itself to new methods of production. The Five-Year Plan recognizes the importance of a social environment conducive to economic progress. The measures for social improvement are no less essential to the establishment of a progressive economy than the many investment projects designed to increase agricultural and industrial production. Economic progress involves the creation of dynamic forces that will carry the economy steadily forward, seeking and finding new fields and new means for expanding production.

The economy of India has hitherto been static, if not regressive. While the forces that have brought this condition about are numerous, one factor has undoubtedly been the inability to provide savings and undertake investment on an adequate scale. It is not possible to state precisely what the rate of savings and investment has been. The investment that takes the form of improvements on a piece of land or in a cottage industry made by the proprietor himself can be estimated only within broad margins of error. It appears, however, that, in recent years prior to the Plan, net savings and investment have been of the order of 4 to 5 per cent of national income. This was apparently enough to provide the tools and equipment to enable a population growing at the rate of 1·25 per cent per annum to carry on production in much the same way and with approximately the same productive efficiency as in the past. It left little surplus for creating an expanding economy.

The purpose of the Five-Year Plan is to raise the level of investment so that, in conjunction with other economic and social measures, aggregate production will begin to rise more rapidly than population. The Plan is intended to raise the level of investment to a little over 7 per cent of the national income and to direct this increase into critical areas that will enable agricultural and industrial production to grow. Investment on such a scale is

still far below the level customarily found in the great industrial countries, and even in many underdeveloped countries. Although this increase in investment is not large, it is vital in order to transform the economy from a stagnant to a progressive state.

There is for every country a critical level of investment necessary to bring about increasing production *per capita*, that is to say, some degree of advance in productive efficiency. An economy that cannot attain such a level of investment, by use of domestic and foreign resources, will stagnate. While some industries may grow, others will decline, and the over-all level of economic well-being may remain virtually unchanged. On the other hand, an economy that can exceed this critical level of investment will succeed in increasing production *per capita* and facilitate the improvement of productive efficiency. With a steadily expanding income, the capacity of the economy to provide savings for further development will be somewhat greater. Although the process may be slow, the economy will make progress, and this progress may gain momentum.

The Five-Year Plan is intended to raise investment to this critical level. In time, when the national income has increased considerably, the economy may be expected to provide enough savings to make economic progress possible on the basis of its own resources. Even then, investment out of domestic resources will still be inadequate to bring about an increase in productive efficiency at the rate which India is technically capable of undertaking. Such a level of investment is possible only if India's own resources are supplemented by foreign resources. Under the most favourable conditions and with the most generous provision of resources, the economic development of India cannot be accomplished in a five-year period. It is a task to which an entire generation and more will have to be devoted. This Five-Year Plan can, however, establish the basis for a progressive economy that will utilize modern means of production and that will be capable of providing the people of India with an improving standard of living.

3. **Development with Stability**

The achievement of the two basic objectives of economic policy requires that the development of India be carried out in an environment of economic stability. Inflation is a socially costly and economically wasteful means of increasing investment. It encourages excessive investment in inventories, real estate, and foreign balances; and it discourages investment in agriculture and certain fields of industry, particularly if controls hold down prices while costs rise. Thus, inflation diverts the limited resources

available for development to sectors where their effect on production is negligible. This is not to deny that there may be a temporary increase in investment as a consequence of inflation; but the experience of many under-developed countries is that after an initial increase, which may continue for perhaps two or three years, socially productive investment may revert to an even lower level than prevailed prior to the inflation.

The problem for India is not to secure a short spurt of a relatively large amount of investment. That has been the problem for certain industrial countries at a time when a once-for-all rapid expansion in particular types of production was necessary. For India, however, as for other underdeveloped countries, the basic problem is to secure a steady rise in investment in many sectors of the economy and over a long period, in fact, until the momentum of the economy and the growth in its capacity to save will make such a level of investment normal. It would be shortsighted to jeopardize the structure of the economy and its growth in the directions suited to the needs of the people for the sake of a temporary spurt in investment induced by inflationary means.

Even in the short run, the problems confronting the Government of India would be greatly intensified by inflation. Inevitably, inflation would impair the international payments position of the country. Exports would become less profitable, foreign exchange receipts would decline. The lack of foreign exchange would make it difficult to acquire the imported equipment and materials required for the Five-Year Plan. If the payments problem should become very acute, even the ability to maintain adequate imports of food grains and other essential goods, not directly related to the development programme, might be threatened. Moreover, it would not be possible to attract foreign capital to supplement domestic resources for development if payments difficulties should emerge and persist.

For these reasons, the Government of India should regard development with stability as its basic economic policy. However, economic stability must not be confused with price rigidity. A growing economy must have sufficient flexibility in its price structure to induce the movement of real resources into those sectors which experience the greatest growth. There may already be excessive price rigidity in India, arising not only from the normal stickiness of prices in an economy in which traditional methods of production prevail but also from the measures taken to control prices. Whatever advantages there may be in price control as an emergency measure, they are likely in the longer run to be outweighed by the distortions in production to which they give rise.

Economic stability is consistent not only with a high degree of price flexibility, but even with some movement in the general level of prices. In every country, a rise in the porportion of the national income going into investment sets up forces that induce an upward adjustment of prices in the sectors in which expansion is relatively large. Such a rise in prices need have little effect on prices in other sectors. This functional rise in prices should not be confused with an inflationary rise in prices. Even if the Government of India had all the resources needed for development, so that there could be no problem of inadequacy of resources, some readjustment of prices would and should occur in conjunction with the implementation of the Five-Year Plan.

It is not always easy to distinguish between a functional rise in prices, which is necessary to attract productive resources into the expanding sector of the economy, and an inflationary rise in prices, which is indicative of the inadequacy of productive resources for the economy as a whole. The essence of an inflationary rise in prices is that it reflects a general excess of demand for goods and labour. For this reason, the whole range of prices and wages is likely to rise. Furthermore, as the rise in prices accomplishes no more than the temporary exclusion of the excessive portion of demand, the price rise will continue so long as the inflation persists. Finally, as inflation is a struggle to capture an excessive part of the real output by government, business, or labour, the price rise will grow in intensity as the inflation continues.

In contrast, a functional rise in prices should be confined to a very limited sector, that is, that part of the economy which is expanding rapidly; even in this sector, the rise in prices should be relatively small, just enough to induce a movement of resources to this sector; and this rise in prices should come to a halt rather soon, when productive resources are moving to the expanding sector on the necessary scale. Obviously, when there is inadequacy of productive resources for development, it is not possible to attract them to the expanding sector to the necessary extent by a limited, functional rise in prices. A persistent attempt to maintain a level of investment for which resources are not available must result in the large, steady, and pervasive rise in prices that is the consequence of inflation.

The major danger of inflation in India arises from the need to finance the Five-Year Plan. If the real resources for development are adequate for the investment it is proposed to undertake, there will be no inflation, although there will be functional price adjustments. On the other hand, if excessive credit is created to finance the Plan because of a deficiency in savings, it will almost

certainly lead to inflation. This does not imply that the creation of credit must inevitably lead to inflation. Some creation of credit is consistent with and even necessary for a stable economy.

On the other hand, excessive caution on credit policy may make it difficult for the economy to generate the resources it is capable of providing for development. It is never possible to have in hand all the resources required for a development programme. By its very nature, most of the real resources for development come into being in the process of production, through taxes and savings arising from current incomes. And the level of current production can be adversely affected by an overcautious credit policy. In determining the scale of the development programme and the measures to finance it, the Government must to some extent rely on estimates of the probable resources that will be available for development. Its policy should, therefore, be bold without being reckless.

As a practical matter it may be said that there are almost never enough resources for carrying out a planned investment programme in an under-developed country. For if investment were going forward on an adequate scale, it would be unnecessary for Governments to undertake planning to bring about the desired level of investment. So far as can be foreseen at this time, the resources available to the Government of India are not adequate for carrying out the Five-Year Plan. It would be tragic if this essential development programme designed to give momentum to the economy of India had to be pared down for lack of resources. It would be unfortunate if the attempt to carry out the Five-Year Plan, despite the inadequacy of resources, should lead to inflation. India must find additional resources that will enable the Plan to be achieved in an environment of development with stability.

II. THE PRESENT ECONOMIC SITUATION

Like most countries, India emerged from the war with substantially higher prices and a threat of a further rise from the excess liquidity that had accumulated during the war—the latent inflation. The dislocations that followed in the wake of partition added to the inflationary pressures. To establish a basis for economic development with stability, it was necessary first to purge the economy of the forces of inflation. The monetary and fiscal authorities have succeeded in doing this during the last few years. The piled-up latent inflation of the past has at last disappeared, Indian prices have been reasonably stable, and the deficit in the balance of payments has been reduced to what can properly be met by the use of sterling reserves. With this restoration of economic stability, the country is now in a position to undertake a larger volume of investment without risk of an inflation that could get out of hand.

1. Prices and Money Supply

Perhaps the best evidence of the internal stability attained in India during the last three or four years is provided by the behaviour of prices (see Table I). The wholesale price index in June 1953 was 10 per cent higher than in 1948. There are few countries in which the price rise over the past five years has been so moderate. Despite the devaluation of 1949, Indian prices in terms of rupees have taken no sharp upward turn, indicating that the devaluation was largely an adaptation of the exchange rate to the inflation that had already occurred. In fact, as in other countries, the devaluation was an essential means of wiping out the remnants of excessive liquidity and the continued threat of latent inflation.

As the wholesale price index is weighted heavily with goods that enter into international trade, it did show a sharp rise and fall characteristic of all raw material prices since the beginning of the Korean War. A price index which reflects the operation of internal monetary and fiscal forces would show greater stability from year to year as well. Such an index can be constructed by taking into account only those goods that are both consumed and produced almost entirely at home. In view of the constant necessity of judging the effectiveness of internal fiscal and mone-

tary policies in maintaining economic stability, it would be extremely useful for the Government of India to publish regularly an index of prices of goods produced and consumed domestically and which would be free as far as possible from the direct effects of external fluctuations.

TABLE 1.—*Indices of Prices in India*

(1948=100)

	1949	1950	1951	1952	1953
Wholesale Prices (all goods).	104	109	120	105	110 (June)
Working Class Cost of Living—					
Bombay .	101	103	109	111	122 (June)
All India .	..	..	..	106	106 (Mar)

Sources: International Monetary Fund, *International Financial Statistics*, for all series except the cost of living index for All India. That series is adapted from the series published by the Reserve Bank of India in its *Bulletin*, March 1953 and June 1953.

The index of working class cost of living also shows reasonable stability. Such indices are available for nearly a score of cities in India, and show somewhat divergent movements. For Bombay, the index shows an increase of 22 per cent in the last five years, but the rise in most other cities is less pronounced. The significance of the actual increase has to be judged in the light of two important factors: in recent years, some of the items included in the working class cost of living index have been decontrolled, and there has also been a reduction in food subsidies.

There are many people to whom the conclusion that inflation has been eliminated in India and economic stability restored will come as a surprise. For more than a decade, inflation made serious inroads into the standard of living of certain fixed income groups among the middle class. This is inevitable when prices rise nearly fourfold and some groups lack the economic power to protect their real income. The inflation that impaired their economic position is an inflation of the past, not one of the present. The test of inflation is not whether prices now are higher than they formerly were, and certainly not whether they are higher

than in the prewar years. The test of inflation is whether aggregate demand exceeds the value of output at current prices. Inflation is indicated by prices that are rising in the present, not by prices that have risen in the past.

It is not, of course, possible to force a reduction of prices in India in order to undo the injustice of the war and postwar inflation. That would necessitate a serious deflation which would, undoubtedly, halt any progress in the economy. This is not to suggest that nothing should or could be done to redress the wrongs arising from the inflation of the past. It is not feasible to do this, however, by inducing a large and continuing fall in prices in order to shift real income to the fixed income groups. The prewar price level is now very largely a matter only of historical interest.[1] Its significance as a base for price indices which might serve as a guide to current problems and current policies is negligible. It would do much to clarify thinking on economic questions if economic indices were now based on a recent postwar year.

One reason why it was difficult to halt the inflation in the early postwar years was the large accumulation of currency, deposits, and other liquid resources that grew out of wartime conditions. The money supply was too large to allow the monetary authorities to take effective measures that could keep prices from rising. This excess liquidity was finally wiped out by the rise in prices after the temporary decontrol measures in 1947, by the sizable decline in the money supply in all the years since 1948 (except the year after the start of the Korean war), and by the growth in production.

In the absence of comparable national income data, and in view of the hiatus created by partition, it is not possible to state categorically that the money supply today is no more than is required for the needs of the economy as indicated by prewar standards (see Table 2). But all the indirect evidence with respect to changes in prices and production points to this conclusion. During 1938-39, the money supply in India averaged roughly Rs. 4·7 billion, or approximately Rs. 13 per capita. If the per capita national product in real terms is no higher at present than before the war, and if there has been no change in the meanwhile in the need for money in relation to income, the normal per capita money supply today should be 3½ to 4 times the supply before the

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[1] A prewar year is used in India as the base for constructing most price indices. In *International Financial Statistics* of the International Monetary Fund all price index series, such as those reproduced in Table 1, have been adjusted so that the index for 1948 equals 100.

war to take care of the rise in prices. The actual per capita money supply today is approximately 50 rupees.

TABLE 2.—*Money Supply in India*[1]

(In billions of rupees)

Date	*Money Supply*	*Date*	*Money Supply*
1947	21·40	1951	18·76
1948	20·28	1952	17·78
1949	18·73	1953 July	18·16
1950	19·36		

[1]Data are for last Friday of period indicated.

Source : International Monetary Fund, *International Financial Statistics.*

There has been a corresponding decline in the liquidity of the banking system, and therefore in the ability of the banks to expand credit on their own initiative. During the war, the commercial banks became highly liquid, and this liquidity showed itself largely in the form of excessive holdings of government securities rather than in the form of excess cash or reserves with the Central Bank. This situation made it possible until recently for the banks to expand private credit by liquidating their government assets. The assets structure of the banks has now reverted more or less to the prewar position.

Before the war, investments in government securities equalled roughly one-third of the total demand and time deposits of scheduled banks, while credit to business and individuals was equivalent to nearly half of the deposits. At the end of the war, investments in government securities were more than half of deposits, and credit to business and individuals only 30 per cent of deposits. During the last year, government investments were again roughly one-third of deposits, and private credit varied between 50 and 60 per cent of deposits. This has made it possible to use monetary policy more effectively. Even if the banks were disposed to liquidate some additional government securities in order to expand credit, they would find it more difficult to do this, since the Reserve Bank abandoned rigid support of the government bond market in November 1951.

Prices in India have been rising in recent months. During the first half of 1953, both wholesale prices and the cost-of-living (Bombay) increased by nearly 7 per cent. Following the two-year decline in prices in India, such a rise need not indicate any

imbalance between money supply and production. It does indicate that in India, as in other countries, the authorities must be ready to use the instruments at their disposal to avoid monetary instability.

2. Balance of Payments

Along with the reduction and elimination of inflationary pressures, there has been a significant improvement in the balance of payments in the last three years. As in many other countries, in India the balance of payments has reflected the changing market for its export goods in the different phases of the Korean War. But these changes cannot disguise the basic improvement in India's payments position. A broad indication of this position is given by Item 6 in Table 3. This item is the total of goods, services, private donations, private capital movements, contractual official payments, and the resources for development provided by the International Bank for Reconstruction and Development, the Colombo Plan, and the U.S. Mutual Security Administration grants. In 1948 there was a deficit on this entire group of transactions of about Rs. 1·1 billion, the equivalent of approximately $330 million. In 1949 the deficit was about Rs. 1·6 billion, the equivalent of approximately $450 million. In 1950 there was a small surplus. In 1951 the deficit reappeared, amounting to about Rs. 700 million, the equivalent of approximately $150 million; and in 1952 the deficit was approximately the same. This deficit is not in excess of the reduction of reserves that the Government of India is willing to have. It is not the magnitude of this deficit, but the need to continue import restrictions, that is the true indication of India's balance of payments problem. The payments problem has not, of course, been solved; but the improvement that has taken place in the payments position has reduced the problem to one of manageable proportions.

TABLE 3.—*Balance of Payments of India*

(In millions of rupees)

	1948	1949	1950	1951	1952[1]
1. Goods, services, and private donations	—555	—1,837	433	—461	—499
2. Private capital movements.	—154	—210	—88	—24	—19
3. Net errors and omissions.	—417	416	—169	—243	—311

TABLE 3.—*Balance of Payments of India*—contd.

(In millions of rupees)

	1948	1949	1950	1951	1952[1]
4. Official contractual payments.	..	—25	—27	—28	—19
5. Official development financing[2]	..	70	116	62	146
6. Total (1 through 5) .	—1,126	—1,586	265	—694	—702
7. U. S. food loan .	..	..	..	380	526
8. Transfer of sovereignty[3]	—2,840	—119	..	—29	—32
9. Monetary movements	3,966	1,705	—265	343	208

[1] Includes transactions with Pakistan.

[2] Mainly IBRD loans, Colombo Plan, Point Four, and ECA/MSA grants for development. Grants from the Ford Foundation, although it is not a government agency, are also included..

[3] Transactions associated with the transfer of sovereignty involved the purchase of the pensions annuity to cover India's liability for pensions to former Indian Civil Service employees, and the purchase of defense stores and installations in India (1948-49), and also the repatriation of Indian currency from Aden (1951-52). These transactions were offset in " monetary movements "—*e.g.*, by the release of blocked sterling balances in 1948-49.

Source : Balance of Payments Division, International Monetary Fund. Adapted from data to be published in the forthcoming *Balance of Payments Yearbook.*

The strengthening of the payments position has been reflected in the behaviour of official reserves. (Table 4). During the one year 1949, the foreign assets held by the monetary authorities in India declined by about Rs. 2 billion, equivalent to about $550 million, at the average dollar exchange rate of that year. In the three years, 1950 to 1952 and the first quarter of 1953 together, the foreign assets in the hands of official entities have been drawn down by only Rs. 1 billion, about $210 million. For a country which accumulated extraordinary reserves during the war and which is in urgent need of resources for development, the use of reserves at the average rate of approximately $65 million per year is obviously not excessive. In fact, the actual use of reserves during the period under consideration has fallen short of the agreed releases of sterling. The large U.S. Wheat Loan of $190 million, of course, helped to minimize the use of reserves in 1951 and 1952. But the loan was in response to an extraordinary misfortune and even when account is taken of this loan, the general

balance of payments situation has improved significantly since the devaluation of 1949.

TABLE 4.—*Gold and Foreign Exchange Assets of the Reserve Bank of India*[1]

(In millions)

	Rupee Value[2]	Dollar Value[2]	Change in Rupees	Change in Dollars
1948 . . .	10,670	3,354	..	..
1949 . . .	8,660	1,982[3]	—2,010	—1,372[3]
1950 . . .	8,740	2,000	80	18
1951 . . .	8,210	1,888	—530	-1 2
1952 . . .	7,460	1,729	—750	—159
1953 July . .	7,440	1,726	—20	—3

[1] Data are for last Friday of period indicated.

[2] The rupee figures include gold at the value at which it is carried in the books of the Reserve Bank. The dollar figures value gold at $35 an ounce.

[3] Reflects change in dollar valuation of assets as well as use of reserves.

Source : International Monetary Fund, *International Financial Statistics*.

There has also been some improvement during the past few years in the payments position with respect to hard currency areas, although this improvement has been overshadowed by a number of other developments. Regional totals similar to those recorded under Item 6 of Table 3 are not available in revised form for the year 1948-52; but the current account balance (*i.e.* goods and services, donations and some unclassified items) gives some indication of the regional payments position[2]. India's deficit on current account with hard currency areas amounted to Rs. 430 million in 1948 and Rs. 490 million in 1949. But in 1950, India actually recorded a surplus of about Rs. 265 million, largely on account of the boom in raw material prices after the outbreak of the Korean War. The reaction to this boom, combined with the large emergency imports of U.S. wheat, led to a sharp deterioration in 1951 and 1952, and the combined deficit for the two years amounted to Rs. 1·8 billion. About half of this deficit is represented by emergency imports of wheat. Apart from these imports covered by the U.S. Wheat Loan, the deficit with the hard currency areas in 1951 and 1952 was about 30 per cent less, measured in dollars, than in 1948 and 1949, although the deficit

[2] Reserve Bank of India, *India's Balance of Payments, 1948-51*, and *Reserve Bank of India Bulletin*, April 1953.

measured in rupees was virtually unchanged. The dollar payments position has improved in 1953, and India actually contributed to the sterling area dollar pool in the first half of the year.

The maintenance of internal stability is essential to, but not necessarily a guarantee of, a satisfactory balance of payments position. The absence of inflationary pressures at home ensures that the home demand for imports and for exportable goods will not be excessive. But the ability of a country to maintain exports depends upon the state of markets abroad and on the adaptability of its export industries to changing circumstances. In recent months, the principal exports of India, *viz.* jute, tea and cotton textiles, have had to face a serious market situation. In part, this reflects the changing character of international markets in which price and quality competition are becoming increasingly keen. While the present position of India's exports is less favourable than it has been, there is no reason for assuming that the export industries will decline. Nevertheless, for the longer run, India needs to diversify its export trade, and this is a problem to which greater attention should be given.

Despite the decline in exports, India has added to its reserves moderately since July 1952. This is due largely to the sharp decline in imports. The decline is likely to be reversed in the coming months in view of the general destocking of commodities evident during most of 1952. The terms of trade for India, which are worse today than they were either in 1948 or before the Korean war, may improve somewhat as demand begins to reflect more fully current needs. While the balance of payments may be regarded as satisfactory for the time being, it is necessary to strengthen the payments position, primarily by expanding exports, in order to meet larger import requirements in the future and service requirements on foreign capital for the Five-Year Plan.

3. Economic Controls

The Government of India has very extensive powers for the control of almost all phases of the economy. During the war, and for a time after the war, many of these controls were used; but with the curtailment of inflationary pressures in recent years, the controls have been relaxed. Apart from price control and some rationing of food grains, they do not extend very much to the consumer level. Nevertheless, they are not without significance to the economy of India, for they affect to some extent production, marketing, and investment in several major industries.

Under existing enabling legislation, the Government possesses extensive powers of control over all major industries. In practice,

these far-reaching controls have not been fully applied. The prices of a few important industrial commodities like steel, coal, and cement are controlled; there is allocation of a few commodities; and there is some control of output as in the case of mill-made dhotis. On the investment side, the Government has the power to license new enterprises and the Capital Issues Control scrutinizes the flotation of new issues.

The most important controls affecting consumers are those relating to food grains. About 28 million—30 million people, mainly in larger towns and cities, are covered by the statutory rationing of food grains.[3] To facilitate the operation of this partial rationing, a compulsory levy at controlled prices is enforced in a number of States. There are also a variety of restrictions on the movement of foodstuffs within the country—particularly from surplus to deficit areas. In order to prevent any undue discouragement of food production resulting from these measures, the prices of some of the other cash crops are also controlled. Where this has resulted in bringing domestic agricultural prices significantly below international prices, it has been necessary at times to restrict exports.

The major justification given for the continued control of food grains is the fear that scarcities may develop if controls are lifted. In particular, it is argued that expenditure on foodstuffs would increase, leading to a rise in prices. The consequent rise in the cost of living would presumably affect wages, leading the economy into higher costs and prices. This price rise could be checked by imports, if even a moderate amount of foreign exchange were used to increase imports. There is informed opinion that the extra imports needed to do away with rationing of wheat without any pressure on prices would be rather small. It is probable that rationing of rice cannot be dispensed with until domestic production increases significantly or imported rice is available at lower prices. There is much to be gained, economically and psychologically, in giving complete freedom to consume the basic food grains of which adequate supplies can be procured. This is true of wheat.

Controls are widely regarded in India as a necessary adjunct to planning. A plan for economic development sets up certain targets for production and envisages certain priorities. These targets and priorities in turn require a certain distribution of resources among different sectors of the economy. This could be accomplished by adjustments in relative prices or by allocations. The distrust if the use of the price mechanism for this purpose

[3]Since the writing of this report, the rationing of wheat has been terminated in most cities.

reflects partly a fear that price adjustments over a wide area are really a form of inflation, partly a feeling that socially important uses might be excluded from the market on a price basis. In fact, it is quite impossible to take into account through controls and allocations the diverse economic considerations that enter into the proper distribution of productive resources in a developing economy. Provided inflationary pressures can be avoided, there are great advantages in allowing the economy a large measure of freedom. The possibility of using controls to check the inflationary pressures that would appear if development were carried out in the face of a serious shortage of resources is further discussed in a later section, Price Controls, Rationing, and Allocations.

The restriction of imports has reflected the payments position of India and the sterling area. In recent years, India's import policy has alternated between successive phases of liberalization and intensified restriction. When the external position has improved for some time, restrictions on imports have been liberalized, partly to permit the economy to absorb the agreed releases of sterling balances. There is naturally a tendency to err on the side of optimism at such a time, and the actual flow of imports becomes excessive. This development is aided by the eagerness of importers to pile up stocks during a period of leniency in view of the uncertainty about future restrictions. When imports become excessive, restrictions are clamped down more heavily, perhaps erring on the side of pessimism.

Such alternations of too much and too little supplies from abroad are not desirable from the point of view of domestic industries. Furthermore, they encourage a speculative attitude toward the holding of stocks of import goods. In all probability the pattern of import goods made available for the people of India is a less useful one because of the sudden changes in import policy. It would be desirable for the Government to set out a longer term import policy based on average expectations over the next three or four years. This would give domestic consumers and producers a more definite idea of what to expect in the way of import policy. Clearly, no hard and fast import plans extending over a number of years can be drawn up; but there is some scope for reducing the variations in the flow of imports from year to year.

While quite often the persistence of controls is indicative of underlying inflationary pressures or severe payments difficulties, the controls that are still in effect in India are largely nominal, with the major exceptions of rationing of food grains and restrictions on imports. These controls do not arise out of inflationary pressures, although foreign exchange receipts are not at present

sufficiently large to allow the removal of all restrictions on imports. There is good reason, nevertheless, to consider the desirability of dispensing with wheat rationing and meeting the needs of consumers through larger imports. As the economy of India is confronted with the need for greater adaptability to the Five-Year Plan, it would be desirable to reconsider the whole range of controls now in effect, and to dispense with those which are not essential to protect the consumption of the lower income groups.

III. THE DEVELOPMENT PROGRAMME, 1951-56

The development programme covers the entire Indian economy, both public and private, and for purposes of analysis may be divided into three parts—the public or government sector, the organized industry sector, and the unorganized sector. The Five-Year Plan sets up a detailed blueprint of development expenditures by the Central and State Governments and a somewhat less detailed blueprint for 42 of the larger industries which provide about two thirds of the total industrial output of the country. For the rest of the economy—the unorganized sector, comprising agriculture, the small factories and cottage industries, private transport, residential construction, etc.—the programme implicitly sets up targets to be achieved by the end of the five-year period. These targets are, of course, related to the expansion in the other two sectors. The Five-Year Plan is therefore essentially a plan for the development of the whole economy. The subsequent discussion is not concerned with the adequacy of the Plan, but with the financial problems to which it gives rise.

1. General Scope of the Plan

The purpose of the Plan is to bring about a general increase in productivity throughout the economy so that national income at constant prices will be increased from an estimated Rs. 90 billion in 1951-52 (the first year of the Plan) to an estimated Rs. 100 billion in 1955-56 (the last year of the Plan). This is to be accomplished by providing the means for expanded and more efficient production, principally through developmental expenditures in the public sector and the organized industry sector, amounting to almost Rs. 27 billion over the five-year period. An effort will also be made to stimulate investment in the unorganized sector, for this sector accounts for a major part of the national income. Although output in the unorganized sector will be increased by investment in other sectors, the attainment of the target for national income depends also on investment in the unorganized sectors.

The Five-Year Plan, as any development programme must, provides for a volume of investment greater than that which presumably would have been undertaken in the absence of the Plan. Net investment is to increase from about 5 per cent of national

The emphasis on agriculture is justified by its basic importance in the economy of India. With perhaps 70 per cent of the persons gainfully employed working in agriculture and about 50 per cent of the national output represented by agricultural production, any significant economic progress must begin with agriculture. Obviously, any rise in the standard of consumption must be based on a larger supply of food grains, and this must come primarily from more efficient agricultural production.

Agriculture will for a very long time be the most important occupation of the people of India. Even a very ambitious industrial development programme can provide employment for only a part of the natural increase in the labour force. Such industrial development would undoubtedly have certain beneficial effects on agriculture by providing equipment, tools, fertilizers, and other materials for more efficient agricultural production. Beyond that, new job opportunities in industry and commerce would relieve somewhat the pressure for employment in agriculture and to that extent affect favourably the productivity of those remaining in agricultural employment.

Useful as these indirect effects of industrial development can be to agriculture, the problem of inadequate productivity can be solved only by providing directly the means for more efficient production in agriculture. A wider knowledge of the proper use of selected seeds, fertilizers, and insecticides and improved techniques in planting and caring for growing crops can have a tremendous effect on yields. The wider use of better methods can be attained gradually as agriculturists learn from each other the improved techniques. An extension service and agricultural courses in the rural schools will increase the receptivity of the agricultural workers to new methods.

It is probable, however, that the willingness of agriculturists to try new methods of production can be sharply increased by making water available to regions that lack irrigation facilities. It is not only that traditional methods of growing must in any case be modified to make use of a regular water supply, but the economic risks of investment in seeds, fertilizers, and insecticides become negligible when their beneficial effect on crops is assured by the availability of water. The key role of water in agriculture is recognized by the large investment to be made in irrigation,—Rs. 1·7 billion is to be spent for major and minor irrigation works and an additional Rs. 2·7 billion for multi-purpose projects. The total area to which irrigation will be brought is about 20 million acres, representing an increase of nearly 40 per cent in the irrigated area.

There is another reason why primary emphasis must be given to agricultural production. A balanced development programme must provide for increasing production in those fields in which there is demand. By far the greatest part of the increase in demand, arising from the higher incomes that will come with the development of the economy, will be for agricultural products. Perhaps as much as one half of the increase in consumer expenditure will be for food grains, and a not insignificant part of the increase in other consumer expenditure will be for cotton cloth. This direct and indirect demand for agricultural products can best be met by an expansion of production within India. For some of these goods, such as rice, supplies are not available from abroad at prices that would make larger imports an attractive alternative to domestic production. In any event, the expansion of agricultural production is necessary if India is not to become excessively dependent on imports of essential consumer goods.

Targets for the principal agricultural crops are shown in Table 6. A substantial increase in food grain production is perhaps the most important phase of the programme. The objective is to permit a small increase in per capita consumption. While it is hoped that by the end of the Plan the need to import food grains will have been eliminated, this will probably not be possible without some control over consumption. The planned increases in raw cotton and jute production are intended to allow a reduction in imports of these commodities and an increase in production of cotton and jute textiles.

TABLE 6.—*Targets under India's Five-Year Plan for Principal Agricultural Crops*, 1955-56

	Output, 1950-51[1]	*Target*, 1955-56[1]	*Estimated Percentage Increase* 1950-51 *to* 1955-56
Food grains (million tons)[2]	54·0[3]	61·6	14
Cotton (million bales) .	3·0	4·2	42
Jute (million bales) .	3·3	5·4	63
Sugarcane (million tons)	5·6	6·3	13
Oilseeds (million tons) .	5·1	5·5	8

[1] From Government of India, Planning Commission, *The First Five-Year Plan* (New Delhi, December 1952), p. 75.

[2] Includes gram and other pulses.

[3] The figure refers to 1949-50, which was chosen as the base for fixing the target for 1955-56. Production in 1950-51 was 52·7 million tons.

4. Development of Industry

While the development of the industrial sector in the initial stages is to be on a smaller scale than that of agriculture, it must ultimately become an important means for the modernization of the economy. As in all underdeveloped countries, there is a lack of work opportunities in fields where efficient production can be undertaken on a substantial scale. The non-agricultural sector must in time provide work opportunities for the whole of the increase in the labour force. While much of the future increase in employment will have to be in commerce, transport and public utility services, the extent to which work opportunities will become available in these fields will depend in large part on the expansion of industry.

The investment in the government sector in power, transport, and communications is a prerequisite for the expansion of industrial as well as agricultural production. In particular, the development of more efficient production in many small-scale establishments, including cottage industries, throughout the country depends on the availability of cheap power. The addition of 1·2 million kilowatts of installed generating capacity, raising the supply of electrical power by more than 50 per cent, will make possible the growth of industrial production in the large cities and the smaller centres of population. At the same time, it will provide more adequate facilities for supplying consumers with electricity.

Estimates of the investment to be undertaken in the industrial sector are, of course, more reliable for the organized private industrial sector, where gross investment of more than Rs. 6 billion is expected under the Five-Year Plan. (see Table 7). A large part of the outlay is for modernization and replacement and to supplement the current depreciation not covered by normal income tax allowances. No doubt, such expenditure on replacement and modernization, even if it does not represent net new investment, results in some rise in the efficiency of production. The substantial increase in production is, however, to be provided by the investment of Rs. 2·33 billion for expanding plant and equipment. A very considerable part of the net increase in investment must go into working capital, in the form of raw materials, goods in process, finished goods awaiting sale, etc.

TABLE 7.—*Distribution of Investments in Organized Private Industry, 1951—56, under India's Five-Year Plan*

(In billions of rupees)

	Planned Distribution
Expansion	2·33
Modernization and replacement . . .	1·50
Working capital	1·50
Current depreciation expenditure not covered by normal income tax allowances. . .	·80
TOTAL .	6·13

Source : Government of India, Planning Commission, *The First-Five Year Plan* (New Delhi, December 1952), p. 436.

TABLE 8.—*Targets under India's Five-Year Plan for Selected Manufacturing Industries*, 1955-56

	Output, 1950-51[1]	*Target*, 1955-56[1]	*Estimated Percentage In* 1950-51 *to* 19
Iron and steel (thousand tons)—			
Pig iron available for foundries. . .	350	660	89
Finished steel . .	980	1,370	40
Cement (million tons) .	2·7	4·8	78
Aluminium (thousand tons)	3·7	12·0	224
Fertilizers (thousand tons)			
Ammonium sulphate .	46·3	450·0	871
Superphosphate . .	55·1	180·0	226
Locomotives (number) .	..	150·0	..
Machine tools (thousands)	1·1	4·6	318
Petroleum refining—			
Liquid petroleum (million gallons) . .	..	403·0	..
Bitumen (thousand tons)	..	37·5	..

TABLE 8.—*Targets under India's Five-Year Plan for Selected Manufacturing Industries,* 1955-56—contd.

	Output, 1950-51[1]	*Target,* 1955-56[1]	*Estimated Percentage Inci* 1950-51 *to* 195
Cotton manufactures—			
Yarn (million pounds)	1,179	1,640	39
Mill cloth (million yards)	3,718	4,700	26
Handloom (million yards)	810	1,700	110
Jute manufactures (thousand tons). . .	892	1,200	35
Agricultural machinery—			
Pumps, power-driven (thousands). . .	34·3	85·0	148
Diesel engines (thousands)	5·5	50·0	809
Bicycles (thousands) .	101·0	530·0	425
Power alcohol (million gallons) . . .	4.7	18·0	282

[1]From Government of India, Planning Commission, *The First Five-Year Plan* (New Delhi, December 1952), pp. 75-76.

No direct estimates of investment in the unorganized sector (agriculture, small scale industry, private construction, etc.) are available. Funds for investment will presumably come from the ordinary receipts or savings of the proprietors undertaking the investment. It is possible that worthwhile investment on a larger scale could be undertaken in smaller enterprises if better provision could be made to provide finance for such investment. As the modernization of the small and medium-sized enterprises in the rural regions could provide full and part-time employment for many people now engaged exclusively in agriculture, there is a need to consider what measures could be taken to encourage a greater development of such industries.

5. International Payments and the Plan

Although there has been a considerable improvement in the payments position of India in recent years, it is necessary to ensure that the balance of payments does not deteriorate under the pressures exerted by the Five-Year Plan and that a new balance of payments is gradually developed, suited to the economy of India as it emerges with development. Furthermore, India's present exports are concentrated on too limited a group of goods,

some of which are highly sensitive to business conditions abroad and whose prices fluctuate rather widely.

During the period in which the planned investment is undertaken, the demand for imports will increase. This increase will take place because of the greater need for equipment and the greater demand for consumer goods. It may be possible to hold this demand in check through intensified restrictions on imports, but this will mean that the economy is deprived of goods it urgently needs. In the longer period, as the economy develops and incomes increase, the rise in production and consumption will necessitate a larger volume of imports of consumer goods, raw materials, and equipment. If India succeeds in securing foreign capital for investment under the Plan, the immediate pressure on payments will be relieved, but it will be necessary in the future to earn enough foreign exchange to meet current import requirements and the service obligations on foreign capital. A balanced development programme must take into account not merely balance in the expansion of the different sectors of the domestic economy but the need to maintain balance in foreign payments.

If the development of the economy is properly related to those fields in which India can expand production efficiently and for which demand can be found at home and abroad, the payments position will reach a proper balance. The targets for expanded production are related to the goods for which a known demand exists at home. To that extent they will result in a reduction of imports or will limit the future increase in imports. For food grains and cotton the expansion of domestic production to meet increased home demand has already been noted. There will also be increases in production of raw jute, fertilizers, aluminium, cement, and artificial silk yarn, all of which will make possible a future reduction of imports. The expansion of production in other fields may limit the future need for imports without bringing about an actual reduction.

It is, nevertheless, clear that a general rise in production and incomes in India will necessitate a larger aggregate volume of imports, not only in the immediate future, but also in the longer run as production and incomes increase. The development of the economy in a manner that will maintain external balance requires a gradual growth in exports to meet the larger foreign exchange requirements of the future. The Five-Year Plan does make provision for an expansion of production in fields in which India has a capacity for meeting competition in world markets. The targets

for expansion of exports (see Table 9) include not only the products which have been traditional exports, but also a more diversified group of commodities, some of which have been of only minor importance in India's export trade.

TABLE 9.—*Targets under India's Five-Year Plan for Volume of Exports of Selected Products*, 1955-56[1]

	Estimated Percentage Increase, 1948-49 to 1955-56
Cotton piece goods	193
Jute yarns and manufactures	7
Manganese ore	223
Oils	167
Coal and coke	164
Black pepper	113
Tobacco	71
Coir manufactures	96
Woollen manufactures	93

[1] Based on data from Government of India, Planning Commission. *The First Five Year Plan* (New Delhi, December, 1952), p. 458.

Apart from the longer range payments problem which is to be met by the expansion of production of export and import goods, the Five-Year Plan presents an immediate payments problem arising out of the higher level of investment called for by the Plan and the higher level of consumption which is incidental to it. Assuming that the programme is carried out as planned, the Planning Commission estimates that there will be a "likely and even necessary" deficit in the balance of payments, at current export and import prices, of about Rs. 1·8 billion to Rs. 2·0 billion per annum in each of the three remaining years of the Plan. If deficits totaling Rs. 5·5 billion to Rs. 6·0 billion were to materialize in the last three years of the Plan, it is clear that they could not be financed merely from the scheduled releases of sterling balances. The financing of the remainder would depend on the availability of additional external aid. If additional external resources are not forthcoming, import controls of varying degrees of severity will be needed to maintain the foreign exchange deficit within the available exchange resources, including the sterling releases.

IV. AVAILABILITY OF RESOURCES FOR DEVELOPMENT

Whether the investment envisaged in the Five Year Plan can be undertaken without giving rise to severe inflationary pressures will depend upon the adequacy of resources. If the total planned investment exceeds the available resources, either actual investment will fall short of the planned investment or inflationary pressures will develop. If the available resources are equivalent to the total planned investment, then there should be enough resources to carry out the planned investment in each sector. An apparent inadequacy of resources for any sector would then be a problem of finance.

1. Investment and Savings During the Plan

The aggregate investment expected in the Plan can be inferred only indirectly from estimates of savings and a target for foreign resources (see Table 10). Over the period of the Plan as a whole, a total of Rs. 27 billion to Rs. 28 billion is assumed to accrue as domestic savings. This estimate is based on the assumption that 20 per cent of the increase in income during the period of the Plan would be devoted to extra savings. If allowance is made for the increase in population during the period, the estimate implies that nearly one-half of the increase in per capita output would be devoted to additional savings and the other half to increased consumption.

The Rs. 27 billion to Rs. 28 billion of domestic savings would be supplemented by foreign resources represented by the balance of payments deficit on current account. The Plan envisages that India's sterling balances would be drawn down by Rs. 2·9 billion. The external assistance assured at the time of the Plan in the form of the U.S. Wheat Loan, the Colombo Plan grants, the Technical Co-operation Agreements, and International Bank loans amounted to Rs. 1·56 billion. The Plan also contemplates an inflow of Rs. 1 billion of private foreign capital during the period. To this must be added any additional foreign grants or loans, of which there have been some, since the Plan was drafted. It is hoped that the total external resources available for the Plan would amount to about Rs. 8 billion. In sum, therefore, the expected total investment, during the period of the Plan, as indicated by total resources, may be put at Rs. 35 billion to Rs. 36 billion.

296 M of F—3

TABLE 10.—*Estimate of Resources Available for Investment in India, 1955-56*[1]

	Estimated Resources (billion rupees)	*Percentage of Total*
Domestic savings . . .	27 to 28	77·5
Foreign resources . . .	8·0	22·5
Sterling balances . . .	2·9	
Assured foreign aid . .	1·56	
Private foreign investment .	1·0	
Additional foreign assistance expected but not assured[2] .	2·54	
Total resources .	35 to 36	

[1]Derived from Planning Commission estimates.

[2] This gap of Rs. 2·54 billion, included as "additional foreign assistance expected but not assured" in the estimated total resources available for investment, is purely residual. It is not directly comparable with the gap of Rs. 6.55 billion in the financing of the Government's own developmental expenditures (Table 11). The latter figure represents the total amounts that the Government expects to obtain from additional foreign aid or by additional taxation, borrowing, or deficit financing (including deficit financing equal to the agreed release of Rs. 2·9 billion of sterling balances).

It should be emphasized that this over-all picture of investment and the resources from which it is expected to come is no more than an indication of the order of magnitudes involved. The basic problem is whether it is feasible to raise this amount of resources. Before any conclusion can be reached, it is necessary to consider the investment and resources available to different sectors of the economy, in particular, the Government and organized private industry. A terminological caution must also be given at this stage. The accounts of the Government are not kept in a form which makes it easy to separate investment expenditure from non-investment expenditure. What the Plan refers to as "developmental expenditure" is not, therefore, synonymous with investment as normally understood, and as implied in the over-all figure of Rs. 35 billion to Rs. 36 billion given above.

2. Financing the Public and Private Sectors

The total developmental expenditure of the Central and the State Governments over the five years is expected to be Rs. 20·7 billion. If this expenditure is to be financed without inflation, it must be met from public savings, loans from private savings, foreign aid, and other unallocated resources. The public savings comprise the excess of government tax receipts over nondevelopmental expenditure and the profits of government enterprises, principally the share of railway profits assigned to the Government. The private savings absorbed by Government comprise loans from the public, small savings, and various special funds which will accumulate during the period of the Plan. As for the remainder, the Government can secure finance through additional taxation, borrowing, foreign assistance, and the creation of credit (see Table 11).

TABLE 11.—*Financing of Government Developmental Expenditure in India*

(In billions of rupees)

	1950-51, *Actual*			*Plan Estimate*, 1951-56		
	Central Govt.[1]	*State Govts.*[1]	*Total*	*Central Govt.*[1]	*State Govts.*[1]	*Total*
1. Public savings	0·94	0·51	1·45	3·30	4·08	7·38
From current revenue .	*0·71*	*0·51*	*1·22*	*1·60*	*4·08*	*5·68*
From profits of railways .	*0·23*	..	*0·23*	*1·70*	..	*1·70*
2. Private savings absorbed by Govt. .	0·31	0·46	0·77	3.96	1·24	5·20
Loans from public.	*—0·11*	*0·08*	*—0·03*	*0·36*	*0·79*	*1·15*
Small savings, etc. .	*0·42*	..	*0·42*	*2·70*	..	*2·70*
Deposits, funds, and misc.	..	*0·38*	*0·38*	*0·90*	*0·45*	*1·35*
Total (1+2) .	1·25	0·97	2·22	7·26	5·32	12·58

TABLE 11.—*Financing of Government Developmental Expenditure in India*—contd.

(In billions of rupees)

	1950-51, *Actual*			*Plan Estimate*, 1951-56		
	Central Govt.[1]	*State Govts.*[1]	*Total*	*Central Govt.*[2]	*State Govts.*[1]	*Total*
3. External assistance already assured	..	..	..	1·56	..	1·56
4. Further external assistance or additional taxation, borrowing, and deficit financing[3]	..	..	..	6·55	..	6·55
Total (1 through 4)				15·37	5·32	20·69

[1] Central Government includes Part C States.

[2] Of this sum, Rs. 2·9 billion, representing the release of sterling balances, is earmarked in the Plan for deficit financing.

Source : Government of India, Planning Commission, *The First Five-Year Plan* (New Delhi, December, 1952), pp. 55 and 62.

The Plan also gives detailed estimates of investment in 42 organized industries, some of which belong to the public sector and as such are covered by the government expenditure of Rs. 20·7 billion. The plans for investment in the organized private sector are worked out in cooperation with the industries; but they cannot represent targets as firm as developmental expenditures in the public sector. It should also be remembered that the outlay in organized industry is not, strictly speaking, all net investment, since it includes items like modernization and depreciation. The total investment in organized private industry is expected to be of the order of Rs. 6 billion, and is to be financed as shown in Table 12.

TABLE 12.—*Estimated Financing of Investment in Selected Private Industries in India, 1951—56*

(In billions of rupees)

	Estimate
1. Private resources	3·50
Corporate savings	2·00
New security issues	0·90
Refunds of excess profits tax	0·60
2. Finance through government institutions	0·25
Assistance from public sector	0·05
Loans from Industrial Finance Corporations	0·20
3. Foreign investment	1·00
4. Bank credit and other sources of short-term finance	1·58
5. Adjustment for double-counting[1]	—0·20
TOTAL	6·13

[1] Part of the foreign investment included in item 3 is expected to flow to public enterprises.

Source : Adapted from Government of India, Planning Commission *The First Five-Year Plan* (New Delhi, December, 1952), p. 436.

Apart from the developmental expenditure of the Government and investment of organized private industry, a substantial amount of other investment must occur in the community. This investment outside the Plan covers a wide and heterogeneous group of activities; *e.g.*, investment by small-scale or unorganized agriculture and industry, investment in residential construction, stocks of goods, or gold and other precious metals, and investment in roads, schools, etc., by local governments and private organizations. It is difficult to make any reasonable estimate of the amount of investment in this area outside the Plan.

The distinctive feature of the unorganized sector is that investment is largely undertaken by the persons that do the saving, including saving in kind, and is to a large extent induced by the availability of savings. Transfers of savings to or within the unorganized sector undoubtedly take place, but they are relatively small. Institutional arrangements for such transfers on any sizeable scale are almost negligible. For this reason, any deficiency of savings in the unorganized sector will result in a prompt and equivalent reduction of investment. In the unorganized sector, the inadequacy of resources is shown by the low level of investment. In the organized private sector and in the public sector, the concept of inadequacy is that available resources are less than the planned level of investment.

3. Adequacy of Total Resources

The estimates of the funds for financing development are precisely equal to the planned level of investment. This does not, of course, indicate that real resources are or will be available for this level of investment. That must depend on the reliability of the estimates of domestic savings and foreign resources. As a secondary matter, for each sector, it must also depend on the functioning of the financial institutions that are designed to transfer savings from those who make them to those who use them. A deficiency of total resources for development will be manifested in a failure to secure finance from sources other than the excessive creation of credit.

About four fifths of investment outlays are to be met from domestic savings of Rs. 27 billion to Rs. 28 billion. For this estimate to be realized, the public and private savings of India must be raised from about 5 per cent of the national income in 1950-51 to about 6·75 per cent of the national income in 1955-56. Small as these ratios are in comparison with other countries, the increase in the savings ratio represents a radical change in attitude toward the use of income. Unless there is reason to believe that savings in 1950-51 were abnormally low for India—and the evidence points rather to the contrary—it is difficult to see how such an increase in savings can be achieved without extraordinary measures by Government.

A priori, it would be expected that in low income countries, the pressure to apply additional income to an increase in consumption would be so great that no significant increase in the savings ratio could be expected. Certainly, it would be unrealistic to count on as large an increase in savings as one half of the

increase in *per capita* income. The introduction of better and more widespread facilities for saving could affect the savings ratio, but that is by nature a slow process. Alternatively, measures by Government to increase tax revenues, to compel additional savings, or to limit consumption, might bring about an increase in savings to the estimated level.

There is no indication that extraordinary measures are contemplated to assure an increase in savings on the estimated scale. The ratio of taxation to national income is not to be increased during the period of the Plan. There is no reason for expecting a decrease in nondevelopmental expenditures of Government that would result in an increase in public savings. It is possible, of course, that by appeal to patriotic sentiment, through the provision of special securities, or through better returns to savers, some increase in private saving will take place. There is a probability, however, that savings, particularly personal savings, will fall short of the estimates in the Five-Year Plan.

It is expected that Rs. 7·4 billion will be provided out of public savings, including the Government's share of the profits of railways. The savings from the current revenues of the Central and State Governments are estimated at nearly Rs. 5·7 billion for the five years. In 1950-51, this item amounted to Rs. 1·22 billion. Despite the expected increase in national income, the five-year estimate is on the high side. In 1950-51, there were some abnormal or non-recurrent items of revenue like export duties and collection of income tax arrears; and nondevelopmental expenditure is expected to increase above the 1950-51 level. The Plan envisages, therefore, some increase in the yield of normal taxes above the base year level. Part of this increase will come with the growth in national income; but a part will have to come from new taxes or an increase in the rates of existing taxes.

Of the Rs. 5·7 billion total of government savings from current revenue, the Central Government's share is only Rs. 1·6 billion, against nearly Rs. 4·1 billion for the State Governments. In order to achieve this target, the States must raise additional revenue of Rs. 2·32 billion over the five years. So far, the progress of the States in achieving this goal has been disappointing. It seems very doubtful at this stage that the States will be able to find their share of the resources required for the Plan unless they impose new taxes in the coming years and reduce their nondevelopmental expenditures.

TABLE 13.—*Tax Revenues of the States in India*

(In millions of rupees)

	1950-51	1951-52	1952-53 (*Revised*)	1953-54 (*Budget*)
Land revenue . .	496	480	609	675
Agricultural income tax .	41	43	38	31
State excise . . .	473	494	444	442
Stamps	222	220	222	231
Registration . . .	38	39	37	37
Taxes on motor vehicles	85	98	110	122
General sales tax . .	563	545	511	547
Sales tax on motor spirit	36	45	58	68
Internal customs . .	87	95	67	61
Other taxes and duties .	179	212	201	215
Total .	2,220	2,271	2,297	2,429

Source : Government of India, Planning Commission, *Five-Year Plan* ; *Progress Report for* 1951-52 *and* 1952-53 (New Delhi, May 1953) *p.* 9.

The increase in State revenues so far is largely accounted for by land revenue (see Table 13). But a large part of this increase will have to be used for compensation of the zamindars (intermediaries) in connection with the land redistribution programme. When account is taken of the fact that the States have increased non-developmental expenditures and developmental expenditure on schemes outside the Plan, the need for additional revenue, to meet the target of savings by the States, remains as great today as it was before the Plan came into operation.

If private savings fall short of the estimate, as there is now reason to expect, the government sector and the organized private sector will not be able to secure the finance they had counted on. The Central and the State Governments hope to absorb Rs. 5·2 billion of private savings over the five years, of which Rs. 1·15 billion is to consist of new loans. The Plan puts the Central Government's share in new loans at Rs. 360 million and the State Governments' share at Rs. 790 million, but this division is not hard and fast. In the first two years new loans made no net contribution to financing the plan; there was, in fact, a net outflow to the public on this account from the Central and the State Governments combined. In recent months both the Central and the

State Governments have raised substantial amounts through new flotations. It is still uncertain whether or not the five-year target for new loans can be reached.

The greater part (Rs. 2·7 billion) of private savings flowing to the Government is supposed to take the form of small savings and unfunded debt (excluding Treasury bills), national savings certificates, Treasury savings deposit certificates, postal savings, proceeds of State Provident Funds, etc. The present annual rate of these savings is close to the average projected for 1951-56, and this estimate should be realized. The sizable item of private savings available to the Government in the form of "deposits, funds and miscellaneous" (Rs. 1·35 billion) is a heterogeneous grouping of accounts which is counted on to yield one fourth of the private savings absorbed by the Government. From recent experience, this estimate is not likely to be reached.

The outlay of the organized sector of private industry is estimated at Rs. 6·13 billion. Some of the sources of finance for this sector, such as assistance from the public sector, loans from the Industrial Finance Corporation, and refunds of excess profits tax, are reasonably assured. Corporate savings in 1950-51 were estimated to be Rs. 400 million. The Plan expects the same rate per annum during 1951-56, that is, a total of Rs. 2 billion. In the absence of adequate information on corporate savings during the first two years of the Plan, it is not possible to form any judgment about the target of corporate savings. As regards new issues, the experience of the last few years is not encouraging and it is not possible to say whether the target of Rs. 900 million can be achieved. Obviously, the claims of the Government and of private industries on savings converge here, and any gain by one may be at the expense of the other.

Apart from domestic savings, foreign resources are estimated to provide Rs. 8 billion for carrying out the Plan. These resources represent about 22 per cent of the total investment contemplated in the Plan. As much of these resources consist of India's foreign exchange reserves, the amount expected in foreign aid and capital is not, in fact, large. The use of releases of sterling balances to the extent of Rs. 2·9 billion depends on the emergence of a balance of payments deficit to which they can be applied. In addition, there was assured foreign aid of Rs. 1·56 billion at the time of the Plan. The Plan further contemplates an inflow of Rs. 1 billion in private foreign investment. About Rs. 650-700 million of this will come from the petroleum refineries, the International Bank loan for the Indian Iron and Steel Company, the expansion of the

Indian Aluminium Company, and additional investment in the railway coach factory.

The Plan envisages Rs. 2·54 billion of additional foreign assistance that is not assured. As already noted, this is a residual item in the sense that the deficiency in aggregate resources for the Five-Year Plan, after allowing for domestic savings and known foreign resources, was expected to be covered by additional foreign assistance (see Table 10). Since the estimate for the Plan was made, additional foreign resources of close to Rs. 350 million have already been received, and further assistance on a modest scale will accrue during the next three years. That would still leave more than Rs. 2 billion of foreign assistance that is needed but not assured, even if the estimate of domestic resources should be realized. Failure to secure this sum would necessitate a reduction in investment unless additional resources could be secured at home.

Some comment is necessary on the two residual items of finance, "deficit financing" in the government sector and "bank credit and other sources of short-term finance" in the organized private sector. These represent the allocation of foreign resources or domestic savings through the instrumentality of the monetary and banking system. Given the availability of real resources, the creation of currency and deposits in an appropriate amount is the means of assuring a suitable monetary policy. Failing the availability of real resources, the creation of credit to meet the residual gap in finance must result in an excessive money supply and the generation of inflation.

4. Experience of the First Two Years

The Plan has been in operation for more than two years and the Planning Commission has put before Parliament a progress report. The experience of these two years should provide practical evidence whether adequate resources are available for investment. The operation of the Plan so far has not generated any inflationary pressures. This basic fact is consistent with three alternative explanations. It may indicate that resources will be adequate for all of the investment under the Plan and throughout the period of the Plan, or that available resources have been above the average in the first two years and may not be adequate in the last three years, or that the level of investment has been below average in the first two years and will have to be much larger in the last three years. The evidence indicates that in fact there was a lower level of investment than planned and an unusual concentration of resources in these two years. Far from indicating an adequacy

of resources, the evidence suggests a shortage of resources in the next three years of the Plan.

The evidence available on developmental expenditure by the Government and in organized industries shows that investment has been lower than the planned level. In the two years 1951-53, the developmental expenditure of the Government amounted to Rs. 5·8 billion, compard with a planned total of Rs. 20·7 billion for the five years (Table 14). To meet the target for development in the public sector, annual outlay in the last three years will have to average 70 per cent higher than in the first two years.

TABLE 14.—*Outlays of the Central and State Governments Under India's Five-Year Plan*

	Central Government[1]		*State Governments*		*Total*	
	Billion rupees[2]	*Percentage of 5-year target*	*Billion rupees*[2]	*Percentage of 5-year target*	*Billion rupees*[2]	*Percentage of 5-year target*
1951-52 (final accounts) .	1·34	10·7	1·28	15·4	2·62	12·6
1952-53 (revised but not final)	1·65	13·3	1·57	18·9	3·22	15·5
TOTAL, 1951-53	2·99	24·0	2·85	34·3	5·84	28·1
1953-54 (budget)	2·37	19·0	1·76	21·2	4·13	19·9
5-year target, 1951-56 .	12·41	100·0	8·28	100·0	20·69	100·0

[1] Central Government includes Part C States.

[2] From Government of India, Planning Commission, *Five-Year Plan : Progress Report for* 1951-52 *and* 1952-53 (New Delhi, May 1953), p. 18.

In the organized industries (public as well as private), investment for expansion in the first two years is tentatively estimated at Rs. 600 million out of a planned total of Rs. 3·27 billion for the five years. To realize the targets, investment in the last three years will have to average nearly three times that in the first two years. As regards the investment of Rs. 1·5 billion for modernization and replacement, real progress seems to have been made in the iron and steel industry. Other important industries, such as jute and cotton textiles, have yet to report definite progress in meeting the investment targets of the Plan.

TABLE 15.—*Public Resources in India, 1951—54, and Estimates of the Five-Year Plan*

(In billions of rupees)

	1951-52	1952-53 (*Revised*)	1952-53 (*Budget*)	1953-54 (*Budget*)	1951-56 *Plan*
A. Savings of public authorities —					
From current revenue	1·90		0·61	0·93	5·72
From railways . .	0·38		0·21	0·20	1·70
B. Private savings absorbed by Govt. Loans from the public . . .	—0·23		0·14	—0·03	1·15
Small savings and other unfunded debt .	0·49		0·54	0·56	2·70
Deposits, funds, and miscellaneous . .	—0·49		0·08	0·29	1·31
C. Total budgetary resources (A+B) .	2·05		1·58	1·95	12·58
D. Foreign aid assured or received . .		1·06			1·56[1]
E. Deficit financing .		1·15			2·90
F. Additional foreign aid, taxation, borrowing, or deficit financing .		..			3·65
G. Total government resources for developmental expenditure (C through F). .		5·84			20·69

[1] Actually some Rs. 1·9 billion is assured in foreign aid so far for the entire period of the Plan. This will permit a corresponding reduction in item F, including "additional foreign aid".

Source : Adapted from Government of India, Planning Commission, *Five-Year Plan* : *Progress Report for* 1951-52 *and* 1952-53 (New Delhi, May 1953), pp. 4 and 7. Slight differences between certain items in this table and comparable items in Table 11 are due to revisions since publication of *The First-Five Year Plan.*

The first two years cannot be regarded as typical of the strain that would be placed on the economy if investment were to be accelerated in the next years in order to realize the targets of the Plan. The first two years have also been unusual in the amount of resources that were available for carrying out the Plan. Because of large extraordinary or non-recurrent revenue in the form of export duties and collection of income tax arrears, government savings were unusually large in 1951-52. In that year, the savings of all government units (Central and State Governments) through the budget amounted to Rs. 1·9 billion, one third of the total planned for the five-year period. (Table 15). The Government also had available during the two years the resources represented by the U.S. Wheat Loan.

There is reason to believe that domestic savings cannot meet the targets set for them, unless extraordinary measures are taken. Public resources for the Five-Year Plan for 1951 to 1954 (the figure for 1953-54 being based on the budget estimates) amount to Rs. 5·6 billion out of a five-year total of Rs. 12·6 billion. To achieve this target, public resources in each of the last two years of the plan will have to be increased by an average of 80 per cent above the level of 1953-54. While detailed data are not available on the resources of the private organized sector, the experience of the past two years indicates that investment is lagging and this must indicate that resources are falling short of the estimates. The experience of the first two years shows that, if the Five-Year Plan is to be carried out, there must be a rapid expansion of investment, and, if this is not to lead to inflation, there is need for substantially more resources than now appear to be available.

The analysis above indicates that resources will not be available for carrying out the investment contemplated under the Five-Year Plan. Domestic savings, private and public, cannot be expected to reach the estimates. A large part of the foreign resources required for the Five-Year Plan is not assured. Active measures will have to be taken to increase the total resources available to carry out the Plan. In the absence of additional resources from domestic and foreign sources, the planned level of investment will result in inflation. The alternative of reducing the contemplated level of investment may result in bringing the volume of investment below the critical level which is essential for giving forward momentum to the economy of India. The succeeding sections consider alternative means through which the necessary resources might be secured.

V. BANK CREDIT AND RESOURCES

The chronic shortage of real resources even for a modest development programme, which is characteristic of underdeveloped countries, has led many business men and economists to advocate the expansion of bank credit to finance development. Some have argued that with the widespread underemployment of labour, no great impetus to inflation would result from the expansion of bank credit for investment to increase production. Others have recognized that such an expansion of bank credit would be inflationary, but argue that the harm done by inflation would be less than the harm done by continued economic stagnation.

1. Underemployment, Credit and Inflation

The view that the expansion of bank credit to finance development is not inflationary starts from the assumption that in underdeveloped countries a considerable part of the labour force is employed in low output work in agriculture. The contribution of such marginal workers to output may be exceptionally small in India because of the limited supply of land. The argument is that the transfer of such workers from agriculture to the construction of dams, roads, and other investments will result in little or no reduction in the output of food. And in time, the investment which is undertaken with their labour will increase the output of food and other consumer goods. The conclusion is then reached that for these reasons the expansion of bank credit to finance development would not be inflationary.

There is sufficient resemblance between this assumed case and reality to regard it as a satisfactory basis for analyzing the inflationary effect of the expansion of bank credit to finance development. If labour is taken out of agriculture and put to work on investment, the workers must be paid wages at a level not less than they earned in agriculture. If agricultural output is not reduced at all by the transfer of labour, then agricultural income will be the same as before. Thus aggregate incomes will be increased by the amount of the investment. With an increase in aggregate incomes, the expenditure on consumption will increase. By definition, there is no present increase in output of consumer goods, and prices will tend to rise.

The fact that investment results in increased production in the future is no assurance that the creation of bank credit to finance

development will not give rise to inflation now. The argument for this policy is based on a mistaken analogy between underemployment in underdeveloped countries and unemployment in industrial countries. In an underdeveloped country, the creation of bank credit to finance development will result in some increase in production of consumer goods in the future, but not sufficient to meet the increase in demand that will be generated currently. In an industrial country, the creation of bank credit to finance investment will result in sufficient increase in production of consumer goods, if there is unemployment, to meet the demand that will be generated currently. Underemployment in an underdeveloped country does not indicate that other resources are available for a prompt expansion of the production of consumer goods. Unemployment in an industrial country does indicate that other resources are available for a prompt expansion of the production of consumer goods.

The question arises whether, at a later stage, when the investment results in a larger output of consumer goods, the same level of investment will also be inflationary. Suppose that after an interval of two years the effect of the new investment is to increase agricultural production *annually* by an amount equivalent to the additional investment financed by bank credit. Even under such circumstances, the maintenance of the same level of investment would generate inflation. The increase in output accrues as income to some part of the economy except as it results in additional tax revenue or is set aside as reserve for depreciation. While some of the increase in income will be saved, most of it will be spent. Thus, the larger part of the increased output is matched by increased expenditure. Only that part which remains as savings, taxes, or depreciation reserve is available to finance the new, higher level of investment.

2. **Money Supply and Economic Growth**

It must not be assumed that, because the creation of bank credit to finance development may lead to inflation, there is no positive or constructive role for an appropriate credit policy. On the contrary, because there is a deficiency of real resources, credit policy must be alert to ensure that a deficiency of money as distinguished from a deficiency of real resources does not further impede development. And it must be alert to ensure that whatever credit is made available through the banking system has the greatest possible effect in increasing production.

As the economy of India develops, a gradual increase in the money supply will be needed. The increase in the money supply

that will be necessary is likely to be not less than in porportion to the increase in production, and it may have to be somewhat more, if industry, commerce, and even agricultural production for the market gains in importance relative to agricultural production for the village community. Such an increase in the money supply is clearly not inflationary; and a smaller increase may prove to be inadequate for the needs of a stable economy.

There are only two ways in which the money supply can be increased: by the acquisition of foreign exchange assets and by the creation of credit. Under the traditional monetary systems, growth in the money supply was invariably linked with accumulation of gold or foreign exchange as a monetary reserve. Even with a more flexible monetary system, there is great merit in the basic principle that some addition to monetary reserves should accompany growth in the money supply. This is so because increased production is likely to be associated with an expansion of foreign trade and larger fluctuations in foreign exchange receipts and payments. That part of the growth in the money supply which is not matched by the accumulation of foreign exchange assets must arise from the creation of credit.

In India, it would not be desirable in the next few years to link the growth of the money supply with the accumulation of additional reserves. For a time, there will be a drawing down of sterling balances. At some stage in the future, the reserves will have been brought into appropriate relation with India's needs. Thereafter, it may become necessary to begin a gradual process of building up reserves to keep pace with the expansion of India's international trade and payments. The time when such a change in policy will be necessary is beyond the period covered by the Five-Year Plan. For the present development programme, growth in the money supply will not be accompanied by any increase in monetary reserves; on the contrary, it will have to be brought about in the face of a decrease in monetary reserves.

The provision of coins, including one-rupee notes, is undertaken by the Government of India through the Ministry of Finance. The supply of coins and one-rupee notes is determined by the needs of the public and the limitations established by law. For practical purposes, this is a negligible part of the broader means for dealing with the money supply. The effective force in the growth of the money supply is the action of the Reserve Bank of India in creating central bank credit and of the commercial banks in creating commercial bank credit. Changes in the cash balances of the Central Government do, of course, act to increase or decrease the

supply of money held by the public, if not offset by other action. In the long run, however, there is little scope for significant changes in the cash balances of the Central Government, although at some times the Government may accumulate large balances and at other times it may draw them down rapidly.

The increase in the amount of money held by the public represents savings matched by real resources that go into investment. Where growth in the money supply is the result of the accumulation of foreign exchange, the investment is represented by the foreign exchange. Where growth in the money supply is the result of the creation of bank credit, the investment is represented by the projects financed by bank credit. The creation of bank credit within the limits of an appropriate money supply makes it possible for the public to hold enough of its savings in the form of money to assure price stability in a growing economy. The allocation of the bank credit among different borrowers affects the direction of investment arising from these savings.

3. **Deficit Financing Without Inflation**

The Government of India is undertaking a considerable part of the investment for development. It is clear that current revenues and the proceeds of loans from the public, including commercial banks, will not provide sufficient funds to meet the requirements of the Government for its part of the financing of the Five-Year Plan. The Government will, therefore, find it necessary to draw down its cash balances and borrow from the Reserve Bank of India. The financing of the uncovered deficit in this way is called "deficit financing" in India; and that is the sense in which this term is used in this Report.

There has been a good deal of discussion of the significance of deficit financing in relation to the Five-Year Plan. This discussion has ranged between two extreme views. On the one hand, there are some people who regard deficit financing as essential for the purposes of the Plan and a healthy means of stimulating enterprise. On the other hand, there are those who regard any deficit financing as inflationary and a serious threat to the stability of the economy. Deficit financing which is used to secure an appropriate money supply and to direct real resources to the Government for its investment is clearly essential to the success of the Plan. If deficit financing is undertaken without regard to its effect on the money supply and the availability of resources, it will inevitably lead to inflation and hamper the achievement of the Plan. Whether deficit financing is desirable or not depends fundamentally on the amount, the environment in which it is undertaken, and the policies that go along with it.

The first consideration in any policy involving deficit financing is whether there are inflationary pressures. If the economy is inflated, then deficit financing can only add to the problem. That was the situation in India some time ago and the public quite properly regarded the deficit financing of earlier years as a factor in this inflation. At present, however, available indices and the judgment of economists, business men, and bankers indicate that there are no significant inflationary pressures in the economy. Under such circumstances there need be no objection to deficit financing, provided the amount of such financing is limited to what is necessary for a sound credit policy, and provided other measures are taken to avoid excessive expansion of the money supply.

There is no formula by which one may determine the amount of deficit financing that may properly be undertaken in the near future. As in most matters involving credit policy, this is ultimately a matter of judgment. It may be assumed that the supply of money is now approximately suited to India's needs. A further contraction in the money supply is not called for, unless there is a very sharp change in the payments position of India. The carrying out of the Five-Year Plan will result in the drawing down of sterling balances. The process by which monetary reserves are used involves a diminution in the money supply equal to the decline in reserves, unless other measures are taken to offset it. As a minimum, therefore, the use of cash balances by the Government of India, and the creation of Reserve Bank credit and commercial bank credit, for the public and the Government, should be undertaken equivalent to the further use of sterling reserves.[4]

It is important to recognize the relation between deficit financing (or other credit creation) equivalent to the use of sterling reserves and the availability of real resources for the Five-Year Plan. The use of sterling balances is already included in the estimate of real resources available for the Plan. Deficit financing or other credit creation to restore the money supply does not increase the amount of real resources; it merely determines by whom the

[4] Creation of credit equivalent to the reduction of reserves attributable to a balance of payments deficit on either current or capital account is not inflationary and, indeed, is necessary to restore the money supply and thereby prevent deflation in a country in which the money supply is properly related to economic policy and the balance of payments deficit is an appropriate deficit that can be financed. In the case of a current account deficit, the credit expansion is necessary to match the additional supply of goods and services available from abroad and enables home investment to exceed domestic savings. In the case of a deficit on capital account, the credit expansion obviates the need to use domestic savings to match the capital outflow and permits the whole of domestic avings to be used for home investment.

real resources should be used. To the extent that the money supply is restored by deficit financing or by government borrowing from the commercial banks, the real resources equivalent to the use of sterling balances are made available for the Government. To the extent that the money supply is restored by the borrowing of business from the commercial banks, the real resources equivalent to the use of sterling balances are made available for the private sector.

The expansion of the money supply, as distinguished from its restoration, does involve savings in the form of cash balances and, therefore, represents an increment of real resources for investment. So long as the expansion of the money supply is no more than enough to finance the larger volume of production, consumption, and investment at stable prices, it is not only not inflationary, but is essential to the proper functioning of the economy. To the extent that the expansion of the money supply takes place through deficit financing and by government borrowing from the commercial banks, it makes available to the Government the resources represented by such saving. To the extent that the expansion of the money supply takes place through business borrowing from the commercial banks it makes available to the private sector the resources represented by such saving.

The Five-Year Plan explicitly takes account of the use of sterling reserves and includes the use of reserves as part of the foreign resources for the Plan. The Plan does not explicitly take account of the savings represented by expansion of the money supply beyond its present level. The assumption is implicitly made that such resources will be allocated through bank loans to the private sector and that these loans will be used to finance inventory accumulations or other investment. It should be possible through credit policy to see that these resources are not directed to less productive forms of investment, but become available in larger part for productive investment within the scope of the Plan or complementary to it.

4. **Credit Policy with Deficit Financing**

Clearly, some deficit financing is consistent with a sound credit policy designed to avoid inflation and to facilitate economic development with stability. Clearly, too, excessive deficit financing is not consistent with a sound credit policy and can lead to inflation even if it is for the purpose of undertaking development. Deficit financing is but one aspect of credit policy, and it is only on the whole range of credit policy that a judgment can be made. The practical problem for the monetary authorities is

to determine how much is proper and how much is excessive deficit financing within the framework of a sound credit policy.

One magnitude of which rough estimates can be made is the aggregate amount of credit creation that may reasonably be undertaken without risking a serious inflation. The money supply at the end of March 1953 was Rs. 18·5 billion [5]. Disregarding adventitious factors, it is probable that, if the economy develops as foreseen by the Five-Year Plan, an appropriate money supply for India by March 1956 (the close of the Plan) would be close to Rs. 19·5 billion. If the drawing down of sterling balances in this three-year period should amount to Rs. 2 billion, it would be possible to reduce the cash balances of the Government of India and increase Reserve Bank and commercial bank credit by a total of close to Rs. 3 billion.

It should be pointed out that such an estimate of the total amount of credit that could be created without risking a serious inflation cannot be set up as a target in the Five-Year Plan. Rather, it should be thought of as a guide to be modified to suit the actual developments in the Indian economy which are the true determinants of the amount of credit that can be created to bring about an appropriate money supply. If output in India grows more than is foreseen by the Plan, there will be a possibility of a larger expansion of credit. On the other hand, if output grows less than is foreseen by the Plan, if the actual use of sterling falls short of the agreed releases, or if the payments position deteriorates, the creation of credit cannot be safely allowed to reach this estimated figure.

Whatever the appropriate amount of credit creation may in practice prove to be, not all of it can be set aside for deficit financing. Even if credit policy could assure that such an amount of deficit financing did not give rise to an excessive expansion of the money supply, it would not be desirable to have all of the resources arising from the use of sterling reserves and savings in the form of cash balances set aside for the public sector. Some of these resources will have to be made available for credit from the banking system to private enterprise if investment is to be undertaken to increase production in agriculture and industry. Apart from this, the banking system would almost certainly expand credit excessively if deficit financing were undertaken to the full amount of the decrease in the sterling reserves and the need of the public for additional cash balances.

[5] Series reported in International Monetary Fund, in *International Financial Statistics*.

Suppose the Government were to draw down its cash balances and the Reserve Bank were to acquire Treasury securities to a total of nearly Rs. 3 billion over three years. This sum would enter into the money supply. To the extent that the deficit financing restores the money supply decreased by the use of sterling reserves, it would not increase the capacity of the banking system to expand credit. Its only effect would be to avoid a contraction of credit that might otherwise be forced on the commercial banks. To the extent that the deficit financing represents a net increase in the money supply, it would make possible a further expansion of bank credit. Part of the increase in the money supply would remain in the hands of the public as currency; but part of it would come to the banks as an increase in deposits. With increased reserves they could expand their loans, unless other action were taken to offset this. The aggregate expansion of credit, through deficit financing and the commercial banks, would be more than the economy requires for financing the increased output at stable prices. Inflationary pressures would then emerge.

It is not possible to say precisely how much deficit financing can be undertaken without risking inflation. As a minimum, it would be as much as the drawing down of sterling reserves. Beyond that, an uncertain fraction, perhaps about one half, of the net increase in the money supply could be used for deficit financing without serious risk of inflation. This proportion is high because a large part of the money supply of India consists of bank notes, so that the expansibility of bank credit on the basis of additional reserves is limited. Even if deficit financing could be safely undertaken to an amount equal to the drawing down of the sterling reserves plus some fraction of the net increase in the money supply, it would not follow that this is a desirable policy.

Deficit financing should be integrated with general credit policy. This means that deficit financing, operating within the proper money supply, must not deprive the private sector of resources for which its need may be financially no less urgent and economically no less justified than that of the Government. With uncertainty about how far the money supply can safely expand, any decision on the amount of deficit financing would have to be provisional. The Ministry of Finance should proceed cautiously, undertaking an amount of deficit financing that would appear warranted in the light of circumstances. If the amount proves not to be excessive, borrowing from the Reserve Bank can be increased and credit policy can be slightly eased. On the other hand, if the amount proves to be excessive, borrowing from the Reserve Bank can be decreased and credit policy can be slightly tightened.

The need for effective credit policy will be greater in the future than in the recent past. The economy of India must be expected to be more dynamic with the increase in investment contemplated in the Five-Year Plan; and the risks that arise from credit policy will be greater in a country in which resources are inadequate for development. The Reserve Bank of India has been successful with its flexible credit policy, and this must now be shaped to deal with new problems. It would be desirable to make the banking system even more responsive to the policies initiated by the Reserve Bank. The risks of an excessive expansion of credit would be reduced and the flexibility of credit policy would be increased if the commercial banks were to resume holding significant amounts of Treasury bills in their portfolios. The Reserve Bank is thoroughly familiar with the technical measures for encouraging such use of bank funds.

5. **Credit Policy for Development**

The carrying out of the Five-Year Plan requires the mobilization of the real resources available for investment. This does not mean that all investment called for by the Plan is to be regarded as having priority over all investment outside the Plan. It does mean, however, that investment that has a great effect in increasing agricultural and industrial productivity should be encouraged at the expense of investment that is profitable but has small or negligible effect in increasing productivity. Greater investment in the private sector, especially in moderate-sized industries and agriculture, may be exceedingly useful for developing production in India. Such producers have no access to the capital market and their need for additional funds can be met only through bank credit.

There are undoubtedly great difficulties in establishing a workable system of agricultural credit in India through the existing banking system. In part this arises from the absence of banking offices in rural sectors, in part from the inability of agricultural borrowers to meet the credit requirements of banks. The Government and the Reserve Bank of India are now studying the problem of agricultural credit and a practical solution will undoubtedly be found. The difficulties regarding adequate credit for industrial purposes are of a different order. They arise almost entirely from the traditional attitudes of the banking system. Industrial enterprises can secure adequate credit facilities for short period and seasonal needs, particularly for financing purchases of materials, processing of goods, and sale of finished products. It is only in connection with the acquisition of machinery and related facilities that adequate credit is not available to industry.

The commercial banking system of India has a conservative tradition based on the concept that deposit banks should remain exceptionally liquid and their lending operations confined primarily to short period credit for commercial purposes. The maintenance of high banking standards is important to a sound economy; and the Reserve Bank should be encouraged in its effort to raise banking standards in India. A well-balanced portfolio of loans, including a large proportion of short maturities, is evidence of high banking standards. An excessive proportion of short-period loans for commercial purposes may merely indicate that the banking system is not providing loans to industry for the modernization and expansion of the economy.

The purpose of having short-dated, liquid loans, as distinguished from sound loans with longer maturities, is to enable banks to contract credit if this should become necessary. For an individual bank, such a contraction of credit might become necessary if it loses deposits and must meet large cash withdrawals or adverse clearings with other banks. For the banking system as a whole, a contraction of credit may be necessary if there is a balance of payments deficit involving a decline in reserves that is not matched by an expansion of Reserve Bank credit; or if there is a contraction of Reserve Bank credit to avoid a balance of payments deficit or for other reasons.

When the cash reserves of banks are as large as in India, even a moderate proportion of their loans in short-dated maturities provides ample liquidity for all practical purposes. A higher ratio of short-dated loans can be justified on other grounds—that such loans are safer or that they are eligible for rediscount at the Reserve Bank. This is a matter of banking practice, not of credit policy. In India the preference for short-dated commercial loans is based on a tradition that emphasizes the need for liquidity by the banking system. As a consequence, the bulk of the available bank credit goes to financing the holding of goods; and very little goes to financing the expansion of production. The need for liquidity is, of course, greater for the exchange banks, which are more engaged in financing foreign trade and whose deposits may fluctuate more sharply with changes in the balance of payments of India.

Although banks give preference to commercial loans, in practice some of their lending does finance industrial expansion. This is obviously so in the case of loans for periods of two or three years or longer for acquiring equipment; and it is so in the case of short-period loans made nominally for holding inventories. Such loans enable borrowers to use more of their own resources

for acquiring equipment. As the loans are often renewed at maturity, they are actually two-year or three-year loans rather than three-month or six-month loans. Such loans, when made to good borrowers, are consistent with high banking standards. They would be equally good loans if made for two or three years and specifically for the purpose of acquiring equipment.

The institutional arrangements for financing private industrial enterprise in India are not adequate. This situation is common to nearly all underdeveloped countries. The reason is that the limited industrial sector cannot provide enough savings out of business profits to finance industrial expansion even on a modest scale. At the same time, the capital markets are not designed to finance the expansion of small and moderate-sized businesses. In the United States, the commercial banks regard two-year and three-year loans for equipment as consistent with good banking practice, provided the aggregate of such loans is not excessive and the borrowers are good credit risks. This is a problem of adjusting banking standards to the needs and traditions of the country. It should be studied by the Reserve Bank of India.

The need to make more adequate provision for industrial credit has been recognized by the establishment of the Industrial Finance Corporation by the Central Government and similar institutions by some of the States. The need may not be fully met by these institutions for two reasons—they may deal primarily with larger industrial firms and their resources may not be adequate. These difficulties could be considerably alleviated if the Industrial Finance Corporation could collaborate with the banks in making industrial loans. There are many ways in which this collaboration could take place. The banks could participate with the Industrial Finance Corporation in loans to their own clients, with or without its guarantee. The banks could take the early maturities of loans and the Industrial Finance Corporation could take the later maturities. This is a matter that should be studied by the Reserve Bank of India, the Industrial Finance Corporation, and representatives of the banking system.

VI. PRICE CONTROLS, RATIONING, AND ALLOCATIONS

Where credit policy is used actively to provide the country with no more than the appropriate money supply that can finance a growing output at stable prices, there can be no inflation arising from deficit financing and credit creation by the banks. At the same time, such a credit policy does not increase the real resources available for development. It merely allocates the real resources represented by the drawing down of exchange reserves and the savings of the public in the form of cash balances. Credit policy could be used to expand the money supply beyond the appropriate amount. Under such circumstances, additional real resources would become available for development, if the response of the economy to the inflation were not of a sort to diminish the availability of resources arising in other ways.

The inflation resulting from the excessive creation of credit transfers real income to profit receivers. It would be a mistake to assume, however, that all of the inflation profits become available for development. The savings of other groups in the community are reduced in an attempt to protect the level of consumption. The consumption of profits receivers is also increased as their real incomes rise. Thus, only a fraction, perhaps only one half or one third of the inflation profits emerge as an addition of real resources for development. And even this is accomplished only at the cost of severe disruption in the economy and grave injustice to large numbers of the people. It has been argued in India, as elsewhere, that the disruption and the injustice caused by inflation can be avoided by controls, while credit creation is used to secure real resources for development.

1. Controls and Real Resources

It should be made clear what controls can and cannot do under circumstances where credit has been expanded excessively because real resources for development are inadequate. As resources cannot be transferred to investment without taking them away from consumption, there must be some reduction in consumption below the scale that would otherwise prevail at the new level of income. No system of controls can avoid that. What controls can accomplish, if they are successful, is to prevent a sharp rise in the real incomes of profit receivers and a sharp fall in the real incomes of other groups in the community. And

controls can prevent, if they are successful, the concentration of the ownership of the newly saved wealth in the hands of the profit receivers instead of the consumers whose consumption is reduced to provide real resources for development.

The inflationary pressures arise from the excessive demand which cannot be met by output. The rise in prices is the response to the excessive demand, and the effect of the higher prices is to restrict the demand to the available output. Although the rise of prices is a symptom and not the cause of inflation, it is the mechanism by which the transfers of income take place. If prices could be prevented from rising, the public would be unable to spend as much of its income as it would wish. The unspent part of the income would remain as the savings of consumers; it would not be dissipated in bidding up prices and transferring real income to profit receivers.

Price controls in one form or another were used in practically all countries during and immediately after World War II. Their effectiveness varied from country to country, and everywhere they were much less effective in holding down prices in the later than in the earlier years. For example, in the United Kingdom, the cost of living rose by nearly 15 per cent between 1941 and 1945; it rose by more than 20 per cent between 1945 and 1949. Wholesale prices of all goods rose by 10 per cent between 1941 and 1945; they rose by 40 per cent between 1945 and 1949. Over the whole period, from the beginning of the war to the end of 1949, the rise in prices was larger in the European countries that maintained price controls throughout these years than in the United States and Canada where price controls were abandoned about one year after the war. Obviously, the important factor was that inflationary pressures were not as great in North America as in Europe.

If prices are successfully controlled, the supply of consumer goods cannot satisfy the demand at prevailing prices. If the excess of demand is moderate, there may be no great harm in permitting consumption to be reduced haphazardly by the exclusion of those buyers who come when supply is exhausted. Where the excess of demand is considerable, however, great injustice would be done by this procedure. To assure a tolerably equitable distribution of the available supply of consumption goods it would be necessary to resort to rationing. As shortages would also appear in the supply of production goods, allocations to business firms would be equally necessary. It should be pointed out that the problem of allocation is far more complex than consumer rationing. Fairly equal access for all consumers to the supplies of scarce goods is socially just and administratively simple. No such

rule can be applied to producers competing for limited materials and equipment to produce an almost infinite variety of goods.

Price controls, rationing, and allocations involve significant real costs of their own. A comprehensive system requires a large and elaborate government organization for its administration. Where trained people are scarce, as in India, the necessary staff can be assembled only at the expense of handicapping other government or private activities. Furthermore, the efforts required to ensure compliance by businessmen and consumers are costly and time-consuming. Experience in many countries indicates that, even with a well-organized and efficient administration, it may prove impossible to enforce the controls in a reasonably effective and equitable manner. The problems increase with the severity and duration of the controls. If the public loses sympathy with the policy and attempts to evade the controls on a large scale, a breakdown in their administration becomes almost inevitable. Since incompletely enforced controls are both unjust and ineffective, these hazards cannot be lightly dismissed.

It should be emphasized again that price controls, rationing, and allocations do not obviate the need to sacrifice consumption in order to secure real resources for development. They serve, rather, as a method of apportioning the compulsory reduction in consumption more or less equitably throughout the community. If successful, the controls would prevent the injustice inherent in the redistribution of income originating in a rise in prices. The creation of credit would provide borrowers with the means of securing real resources; the corresponding savings would be accumulated by those whose consumption is curtailed. The accumulation of such savings is a partial offset to the sacrifice entailed in restricting consumption.

2. **Broadening Area of Controls**

The philosophy underlying controls is that a rise in prices would be followed by a demand for a rise in wages in order to restore the level of consumption, while stable prices with controls would be accepted without insisting on an unrestricted level of consumption. The key element in this philosophy is the necessity of avoiding a rise in the cost of living. Some of the advocates of the view that inflation can be suppressed in this way seem to believe that price controls and rationing will be necessary only for food grains, cloth, and perhaps a few other goods of special importance. The experience with controls in most countries, however, shows that in order to assure the effectiveness of the basic controls it becomes necessary to extend the regulatory system more and more widely.

Effective price controls and rationing of necessities leave the public free to try to buy other things with a part of the income that otherwise would be spent for necessities. This spill-over of purchasing power, if not checked, causes prices of other goods to rise, makes their production more profitable, and induces producers to shift production from necessities to non-necessities. Producers of controlled goods cannot afford to pay as much as other producers for scarce materials or labour. To stop this diversion it is necessary to put price ceilings on more and more commodities and attempt to check the production of non-essentials by limitation orders, allocation of materials, and the like. Thus the network of controls becomes very wide even though the original purpose may have been only to assure an equitable distribution of necessities.

If there are any parts of the economy in which there are enough unused resources to permit an increase in production without diverting labour, materials, or equipment from other activities, a spill-over of spending into these areas will be harmless and even desirable. Although there may be some possibilities of this nature, especially as regards services, they cannot be of great importance in India.

In general, controls must be operated in an environment of scarcity. Where real incomes are low, the demand for the particular types of consumption on which income would be spent is likely to be very inelastic. There is thus extraordinary pressure to offer illegal prices for supplies outside the official ration, and these higher prices become an inducement to divert supplies from official channels into black markets. It becomes necessary to extend controls over supply as well as demand.

As controls continue in force and become broader in coverage they make for inflexibility in cost-price relations. For example, the prices of industrial raw materials, if rigidly controlled, cease to reflect the influence of relative scarcity or abundance. The process of development always requires important shifts in the use of economic resources. One of the functions of the price system is to facilitate this shift by making the new uses comparatively more attractive than the old—a simple case of a functional price adjustment. The most skilful administration cannot hope to anticipate all these shifts and to achieve by regulation a close approximation to the operation of a free price system. The usual course is to attempt to hold prices rigidly, making changes only as they become obviously inescapable.

Price controls may lead to wasteful use of materials. For example, steel, being in short supply, is subjected to price control.

By keeping down the price of steel, the community forgoes the opportunity of employing a powerful incentive for careful use of the material. At the controlled price it will become necessary to allocate steel, just as rationing must accompany price control for basic foods. If the price of steel were allowed to rise, every businessman would be given an economic inducement to shift to another material of which the relative supply is greater than for steel. The pattern of relative prices of raw materials is a powerful force to induce successive substitutions of less expensive materials which are more plentiful for more expensive materials which are scarcer.

Controls also result in a domestic cost-price structure that is out of line with world prices and production costs. Imports and exports, therefore, become less responsive to changes in the outside world and greater reliance must be placed on import and export controls and exchange restrictions. These problems are familiar ones in India and need not be elaborated. It is only necessary to mention that if internal prices of grain, for example, are kept below the world level it will be necessary to restrict exports and to subsidize imports. If, to take a different example, the price of raw cotton is held down at home while the price of commercial fertilizer is equal to the world price, Indian growers will have less incentive to apply fertilizer than will growers in other countries and India's relative output is likely to suffer.

3. **Effects on Production and Supply**

The establishment of controls to deal with excessive demand requires comprehensive regulation to restrict consumption and use of goods of all kinds and to assure the flow of supplies to those authorized to buy such goods in specified amounts at regulated prices. In a country like India, large in area, where production is undertaken by innumerable small producing units, with small incomes, and with supplies of the most essential goods barely adequate for needs under ordinary conditions, such comprehensive regulation presents a formidable administrative problem. These difficulties are certain to be enhanced if the controls are retained for an extended period. For after a time, controls affect the incentive to produce and the willingness of producers to supply output for controlled markets.

Where production is organized on a price-cost basis, the ability of producers to maintain and expand output depends upon their receiving a remunerative price. The complexity of the pricing process compels the authorities to depend primarily on

the maintenance of the price relationships existing at the time the controls are imposed. As these prices are not all equally remunerative, there is a tendency for producers to concentrate output on those goods whose price-cost relationship is most favourable. These are likely to be, although not necessarily, the higher-priced goods of each type. To assure low-income consumers a proper proportion of the output, it becomes necessary to regulate the types of goods produced, as under the utility goods schemes in various countries.

An effective system of price controls inevitably requires the control of costs, including wages, materials, and equipment. Where costs cannot be controlled, or cannot be prevented from rising even with controls, there will be a need for repeated adjustment of prices to assure a proper relationship with costs. As costing necessarily lacks precision, particularly when output cannot be maintained at levels for which capacity is installed, there is great risk that the proper relationship of price to cost will not be established. Business firms may be induced to reduce or to limit output because regulated prices are regarded as too low to cover costs, including reasonable profits. Acute shortages of particular goods may develop for this reason.

Even if prices and production are successfully controlled, the restrictions on consumption may affect the willingness to work or to sell output. Restrictions on consumption provide resources by preventing the public from spending a part of its income. The resulting forced savings, by definition, appeal less to the income recipients than the goods they would buy if they were allowed to do so. If controls continue, the accumulation of money which cannot be spent will in time become less and less attractive. Workers may not be motivated to put in extra effort to earn money to add to unwanted savings. Cultivators will almost certainly prefer to consume more of their food grains if they are forced to save money that they would prefer to spend or if they are able to spend money only for goods that appeal to them less than more food.

The principle is the obvious one that income encourages work because it can be used to buy goods. For a time, people may pile up money claims which they confidently expect to be able to redeem in the near future. But as rationing persists, the motivating power of unspendable money begins to weaken. That is why absenteeism becomes a serious problem in countries in which consumption is rigidly restricted by rationing, and why the most thoroughly controlled economies are ultimately compelled to devise consumption incentives to maintain work standards.

Quite apart from the discouraging effect on production, comprehensive controls are likely to hamper the flow of supplies. Because goods have a premium over money, consumers are induced to buy goods whenever they can get them and to hoard goods in preference to holding money. This is the familiar experience that people will take up a ration in full even when it is more than they would buy under free conditions. For business men, inventories in all stages of production tend to be held in larger amount than necessary. As prices always creep up, and may ultimately burst upward even with the best system of price controls, speculation in inventories is certain to prove profitable. That is why inventory control becomes a common feature of every comprehensive system of price fixing, rationing and allocations.

In agriculture and in small industrial units, particularly cottage industries, the difficulty of securing goods induces producers to circumvent the restrictions by marketing their output outside the usual commercial channels. In small, relatively self-sufficient communities, this can be done by trading agricultural products for cloth and other consumer goods. For larger producers and for higher income consumers, black markets with their higher prices and their availability of supplies outside the ration become important alternatives to the fixed-price, rationed market. In time, such markets acquire a tinge of respectability and even legality as parallel markets or free markets.

If controls are successful in preventing an active inflation, their incentive effects and welfare implications, with the passing of time, come closer and closer to those of an especially severe form of taxation. Comprehensive rationing in practice comes to resemble a tax imposed at extremely high rates on all money income in excess of that required to buy the rations at controlled prices. An individual cannot hope to increase his family's present consumption of rationed goods to any significant extent by working harder or bringing more produce to the market. Of course, it would be possible to relate the size of the ration to the amount of work done or the quantity of agricultural products marketed, but this would conflict with the egalitarian philosophy which is usually urged as the justification of rationing. In contrast, the ordinary tax system, which allows some increase in consumption with a larger money income, may actually impel the worker to try to earn more or the farmer to sell a larger part of his crop. When the people begin to respond to these implications of rationing, and they will not be long in doing so, its psychological and political advantages over outright taxation also tend to disappear.

4. Controls and Inflation

Any general expectation that prices can be kept from rising by any system of controls, however comprehensive, when there are persistent inflationary pressures, is certain to be disappointed. In one form or another these pressures gradually act on prices. No country that has had extensive experience with controls has been able to avoid at least a gradual rise in prices. That has been the experience of India in the war and postwar periods; it has been the experience of countries more plentifully supplied with goods and in which the administrative difficulties were far less formidable than they would be in India. The most successful experience with wartime price controls involved a wartime rise in the cost of living of about 20 per cent (somewhat less for Canada, somewhat more for Australia). This was for high-income countries which are normally very large exporters of foodstuffs. India could not hope to do as well.

Few people would argue that controls should be expected to do more than slow down the rate at which prices rise in response to inflationary pressures. Even a modest rise of 5 per cent per annum in prices -and that would indicate very successful use of controls - would, after a few years, bring considerable distortion in the Indian economy and result in grave injustice to large numbers of people. After eight years, covering the completion of the present Plan and another Five-Year Plan, the cost of living would be nearly 50 per cent higher than at present. To superimpose such a rise in prices on the large rise that took place between 1940 and 1950 would be to compound the injury that has already been suffered by many people whose incomes cannot respond to inflation. Nor is there any way of making certain, through the use of controls, that the rise in prices will not be considerably greater than 5 per cent per annum.

The task of development with which the people of India are confronted is not one of providing an extraordinary amount of real resources for a relatively short period of time. Development requires a larger flow of resources into investment for a generation or more if India is to escape from poverty and stagnation. The people cannot be expected to pile up forced savings which they will hold in more or less liquid form, but for which there can be no use in consumption over so long a period. In one way or another these savings in the form of money or money claims, in excess of what people wish to hold in preference to current consumption, will have to be removed if the economy is to continue to function efficiently.

There are only two ways in which this can be done. One would be to allow the forced savings gradually to be used for consumption expenditure. As the output of consumer goods in the future will at best be only enough to meet expenditure out of current income, this will involve activating the latent inflation represented by these accumulated savings. Even if controls are continued indefinitely, these savings, as they rise higher and higher, will at last break through the controls, and the money savings will be dissipated in open inflation. In practically no country could the public be induced to continue to hold the unwanted wartime savings resulting from price control and rationing. In the end, by allowing prices to rise, the savings gradually disappeared, until they no longer exerted pressure on the economy.

The other way to remove the unwanted savings that impede the operation of the economy is to confiscate them through a monetary "reform". Even in the most thoroughly controlled economies of Eastern Europe, it was impossible to make the price and rationing systems work under the pressure of these piled-up and unusable savings. That is why these countries have had to resort to monetary reforms which wiped out a large part of past savings in the form of currency, deposits, and even government bonds. The resentment created by such reforms, in which the Government confiscates the savings accumulated by consumers as a result of restrictions imposed on their consumption, is even greater than that caused by inflation.

A system of controls that is terminated by a burst of inflation or by confiscation of savings cannot be regarded as an acceptable means of securing resources for development in a democratic country in which the Government is concerned with the well-being of the people. Either course means that the promises implicit in rationing would then turn out to be equivalent to a form of taxation in practice as well as in theory. Moral questions aside, a government should recognize that either open inflation or monetary reform weakens the urge to accumulate money savings in the future and thereby complicates a financial programme relying on either voluntary or forced saving.

Price controls and rationing in conjunction with credit expansion do not offer a solution of the problem of inadequate resources. The controls are difficult and costly to administer. Their successful enforcement on a comprehensive scale and for a long period of time cannot be taken for granted and might prove impossible. The controls involve economic costs in the form of rigidities, waste, and disrupted production. If long continued, they weaken incentives to work and to supply goods in exchange

for money. In the long run, the resources for development—and development is a long run problem—must come from taxes or savings out of the current income of the people, or they must come from resources provided from abroad. The problem of inadequate resources must be faced and met. It cannot be hidden by the excessive creation of credit reinforced by controls to avoid an obvious and active inflation.

VII. ADDITIONAL HOME RESOURCES

If the Five-Year Plan is to be achieved without risking serious inflation, measures will have to be taken to secure a larger amount of resources from current domestic output. As has been pointed out, the Planning Commission has assumed that the public will voluntarily save a very large fraction of the increase in income that is expected to take place in the period of the Plan. In view of the low income per capita prevailing in India and the modest increases that may occur, it is difficult to believe that the desired savings will come about automatically. Careful consideration will need to be given to policies that will stimulate saving, by both business firms and individuals; and to make up a deficiency in voluntary saving it may be necessary to rely on compulsory measures, such as social security contributions, taxes, and higher prices for services of public enterprises.

1. Savings and Social Security

Private Saving.—An important part of the resources for the Five-Year Plan is expected to come from the savings of individuals. The Government has placed great stress on encouraging small savings and mobilizing them for investment in the public sector. The small savings programme has contributed a worthwhile sum to government resources in recent years. This programme includes deposits in post-office savings banks, national savings certificates, and Treasury savings deposit certificates. The net increase in savings under the programme has been as follows:

1948-49	Rs. 300 million
1949-50	262 „
1950-51	334 „
1951-52	356 „
1952-53 (revised estimate)	440 „

This record is encouraging. Additional efforts might take the form of extension of postal savings facilities to more post offices, particularly in villages, and more publicity and promotion for small-denomination savings certificates and stamps. Although the immediate increase in savings might be small, and the cost of acquiring such savings high, the campaign would be desirable as

a means of fostering thrift and of giving the public a sense of participation in the development programme.

In the organized sector of the economy, self-financing by business firms must provide an important part of savings. Reinvestment of business profits has been and continues to be a major source of capital formation in the industrialized countries. In India, medium-sized and large-scale enterprises can be expected to do a substantial amount of saving by reinvesting earnings, if business is profitable and there are good opportunities for additional investment in the industries in which these firms operate. Business will not be able to save if price controls squeeze profit margins too tightly or if taxes are excessive. Both the remaining price controls and taxes on corporate profits should be re-examined with a view to facilitating internal financing by business of capital outlays for replacement and expansion.

Social security. Old-age, disability, and survivors-benefit plans and, to a lesser extent, other social security programmes typically require current contributions from employees and employers to finance future benefits. From the point of view of the beneficiaries these schemes give rise to savings. They create a net addition to national savings so long as current contributions exceed current benefit payments. For a system based on actuarial principles and financed entirely by contributions of employees and employers, this will be true (1) of a new plan under which participants do not become eligible for full benefits until they have contributed for a period of years, or (2) of an established plan if the number of participants and their wage levels are growing year by year.

Compulsory contributions by employers and employees are more acceptable than equal amounts of ordinary taxes because of the direct relation between benefits and contributions. Nevertheless, social security contributions, like ordinary taxes, are subject to economic limits when they unduly compress consumption standards of workers or add excessively to employers' labour costs. Furthermore, social security plans may result in an expansion of welfare expenditures of government rather than in net savings, if benefits are not conservatively related to the contributions of workers and employees.

With these cautions in mind, it may be worth noting in general terms the actual experience of other countries with social security systems. Several countries, underdeveloped as well as highly developed ones, have succeeded in securing large supplements to

private and government savings through their social security systems. On the other hand, in a few countries social security contributions of employers have been set so high as to bring about inflation through an excessive rise in labour costs. And in some instances, social security benefits have been increased so far beyond the contributions of employers and employees as to bring about budgetary difficulties for the government in meeting the obligations of the social security system.

If the Government of India can keep social security contributions and benefits within the capacity of the economy, it will for an extended period secure net savings from a social security programme. The compulsory provident funds, organized under legislation which became effective in 1952, provide a useful foundation for such a programme. At present, these funds cover factories employing fifty or more persons in six industries: textiles iron and steel, cement, engineering, paper, and cigarettes. There are also funds for coal mining and government employees, under separate legislation. Although it is advisable to proceed cautiously with a new plan, consideration should be given to the gradual establishment of a comprehensive social security system covering all persons engaged in commerce and industry in firms employing, say, ten or more persons.

2. Taxation

Adequate taxation is especially important in securing resources for development, in view of the large role assigned to Central and State Governments in the Five-Year Plan and the difficulty of increasing private saving. Taxation is a direct method of assuring that the required portion of any increase in national product is diverted from consumption and made available for development. The tax system, however, can provide resources for development only if the revenue yield exceeds the amount necessary to cover ordinary government expenditures of a nondevelopmental nature. The following comments relate to a few general issues respecting taxation as a means of obtaining resources. A comprehensive survey of the revenue system is being undertaken by a high-level Taxation Enquiry Commission recently appointed by the Government.

General considerations.—In 1950-51 the yield of Central and State taxes was only about 7 per cent of national income. The Five-Year Plan assumes that this relationship will be approximately maintained, with tax revenues rising by about Rs. 700-800 million a year by 1955-56 and national income by Rs. 10 billion.

Although the increase in revenue would only parallel the projected rise in national income, an increase in present tax rates would be required to maintain this ratio, in view of the fact that some non-recurrent receipts from export duties and arrears of income tax were collected in 1950-51.

The ratio of taxation to national income is much lower in India than in the industrialized countries, and appears also to be considerably lower than in some neighbouring countries (Ceylon and Burma, for example) and in some of the larger Latin American countries. Although this comparison is of limited significance, in view of economic differences among the countries and shortcomings of the basic statistics, it does suggest the feasibility of larger tax revenues in India. Admittedly, the scope for additional taxation is limited, because a reduction of consumption brought about by heavier taxes on lower income groups would cause great hardship and might impair health and working efficiency. As regards higher income groups and business firms, increased taxation would not augment resources for development by the full amount of its yield because a considerable part of the revenue would be at the expense of private savings.

Taxes levied to finance economic development are likely to be less burdensome than taxes that cover expenditures for defense, administration, and other ordinary government functions, if the development outlays yield a prompt return in the form of increased output and income. Furthermore, the diversion of private savings to public developmental purposes through taxation of the saving groups affects the country's productivity less than use of these resources for current government operations. These generalizations do not mean that government expenditures for current operations are necessarily wasteful; they imply merely that a poor country should economize on public as well as private consumption in order to secure resources for development.

The Central and State Governments should give special attention to the possibility of increasing (a) taxes that have not kept pace with rising prices and revenue requirements over the past ten or fifteen years, (b) taxes and charges that will claim a part of additional income directly attributable to the Five-Year Plan, and (c) taxes that will restrain unnecessary consumption.

Important changes have occurred in the relative yield of the principal taxes in India since 1937-38. (see Table 16). Perhaps the most striking development is the growth of income taxes, but Central excises have also expanded greatly in relative importance and State sales taxes have emerged as a major revenue source.

These changes indicate that the tax system has exhibited considerable flexibility in the past and encourage the belief that it can be adapted to future needs. At the same time, the figures point to the inelasticity of yield of land revenue and of stamp duties. Although customs duties have declined in relative importance, they have responded fairly promptly to changes in imports and exports and now yield roughly the same amount as the income taxes.

TABLE 16.—*Percentage Composition of Tax Revenue, Central and State Governments of India, Selected Years*

	1937-38[1] (1)	1944-45[1] (2)	1946-47[1] (3)	1950-51 (4)	1952-53[2] (5)
Taxes on income[3] . .	11·8	48·0	36·6	28·2	26·4
Customs . .	34·1	10·2	20·8	25·0	26·9
Central excises . .	5·7	9·5	9·7	10·7	12·0
State excises[1] . .	10·9	11·4	11·9	7·8	6·8
Land revenue . .	19·8	7·9	7·0	8·2	9·3
Sales tax . .		2·2	3·0	8·8	7·8
Stamps . .	8·2	4·1	4·6	3·8	3·6
Other taxes . .	9·5	6·7	6·4	7·5	7·2
TOTAL .	100·0	100·0	100·0	100·0	100·0

[1] Undivided India.

[2] Revised estimates.

[3] Includes agricultural income tax.

Sources : Data in columns 1-4 are from Government of India *Report of the Finance Commission*, 1952 (New Delhi, 1953) pp. 40 and 55. Data in column 5 are based on figures from Government of India, Planning Commission, *Five Year Plan: Progress Report for* 1951-52 *and* 1952-53 (New Delhi, May 1953), p. 9; and *Explanatory Memorandum on the Budget of the Central Government for* 1953-54 (New Delhi, 1953), pp.1 and 10.

Land revenue.—This source of revenue has lagged conspicuously behind other major taxes and behind the rise in money incomes and prices. Since 1937-38 it has fallen from second to fourth place among tax sources. Before the war, land revenue accounted for almost one third of the revenue that the Provinces of undivided India raised from their own sources (*i.e.*, total Provincial revenue minus devolution of revenue and grants from the Centre). In 1951-52 land revenue represented less than one sixth of State revenue from own sources.

This trend is the continuation of a long-term downward movement in the proportion of receipts from land revenue. The trend is partly attributable to the rise of new sources of revenue; but the change is also attributable to the failure to adjust land revenue to the rising price level. Although land revenue has increased in money amount, it represents less buying power and a smaller proportion of agricultural output than before the war. The most consistent statistical series on Provincial-State finances is that for the seven Part A States that were not partitioned. In 1951-52 these States collected about 50 per cent more land revenue than in 1938-39, whereas the index of wholesale prices of major agricultural commodities averaged more than five and one-half times the 1938-39 average. Since 1951-52 land revenue has increased to some extent and agricultural prices have receded. Nevertheless, a great discrepancy persists between the rise in prices and the yield of land revenue.

The rise in prices of both agricultural and other commodities and the consequent reduction in the real yield and real burden create a strong presumption in favour of a substantial increase in land revenue. The case for increased land revenue does not rest on any assumption that farmers' real incomes have increased proportionately to agricultural prices. Clearly they have not. Nevertheless, regardless of the size of the producer's marketable surplus or the development of other prices and costs, the rise in agricultural prices has lightened the real burden of land revenue simply because the payment now represents a much smaller amount of agricultural produce and a smaller proportion of the gross yield of land. Furthermore, the decrease in real yield of land revenue has come about by default rather than by deliberate decision.

It may not be desirable to attempt to raise land revenue proportionately to the increase in agricultural prices, as the levy may have been unduly burdensome in the late 1930's and prices of agricultural commodities may fall somewhat below the present level. Even so, it should be possible to raise significantly more from land revenue than the Rs. 340 million which the Five-Year Plan calls on the States to raise over the whole period of the Plan from taxation on land, that is, land revenue and agricultural income tax. Since 1951-52, the States have increased land revenue appreciably, by more than Rs. 100 million in 1952-53 (revised estimates) and by a further Rs. 70 million according to the 1953-54 budgets. A considerable fraction of this increase, however, has been realized in connection with the abolition of intermediaries (zamindars) and is earmarked for their compensation. This part of the land revenue represents neither an increase in the burden on cultivators nor an addition to the net receipts of the States.

It probably will not be feasible to restore the real yield of land revenue immediately. But it is desirable to act as promptly as possible to obtain more from this source, both because of the urgent financial needs of the States and because further delay will strengthen economic and political objections to the adjustment. A systematic reassessment of land is a time-consuming process. It may be feasible, however, to adopt a system of surcharges to existing land revenue pending completion of new assessments.

Import duties and excises.—A variety of taxes can be used to restrain consumption and provide additional resources for development. Although import duties and excises are the most selective measures, other taxes also have this effect. In a country like India there is a fairly sharp distinction between the goods consumed by the poor and those bought by higher income groups. It is possible, therefore, to impose consumption taxes that will not significantly burden the lower income groups. It is less easy to raise large amounts from such sources, however, without further depressing the standard of living of the middle classes, which include many people who have already been severely squeezed by inflation.

The Central Government now imposes customs duties on virtually all imported consumer goods except food grains, and levies excise taxes on a number of domestically produced consumer goods. There remain a few items that many governments consider suitable for excise taxation that are not especially taxed in India, and it may be possible to raise rates of some import duties and excises. To some extent this policy was adopted in the 1953-54 budget, which allows limited import quotas for semi-luxuries (toilet articles, certain textiles, etc.) and imposes high duties on such articles. A detailed study would have to be made to determine whether any large amount of revenue can be obtained from such taxes on imports and home goods.

Income and profits taxes.—If incomes are converted at the official exchange rates it appears that income and supertax rates are higher in India than in the United States and Canada and only a little lower than in the United Kingdom at most income levels. This method of comparison, however, exaggerates the severity of the Indian income tax. One reason is that the internal purchasing power of the rupee is probably greater for the goods and services bought by higher income groups than is indicated by the official exchange rates. More important is the fact that a given amount of money income places a person higher in the social and economic scale in India than it does in the United States or the United Kingdom. An income of Rs. 15,000 for example, "means more" in India than an income of $3,150 in the United States. This

income would be rather less than the average wage for factory workers in the United States, but in India it would place its recipient well toward the top of the income pyramid. On the other hand, the absence of exemptions for dependents and the practice of taxing Hindu undivided families as a unit (with only twice the usual exemption limit) make for a comparatively heavy tax on large families

The Constitution reserves to Part A and Part B States the power to levy taxes on agricultural income. Several States have not used this power; and in the States where agricultural income taxes are imposed the rates are generally lower than those of the Central Government tax on non-agricultural income, especially in the higher ranges of income. The failure to make full use of agricultural income taxes seems anomalous in view of the dominant role of agriculture in the economy. Land revenue, which is in the nature of a fixed charge, does not seem to be an adequate substitute for a graduated tax on net income. If land revenue and other expenses are deductible, there is a strong case for taxing net agricultural income at the same rates as income from other sources. With the present exemptions, the tax would apply mainly to the diminishing group of landlords and to plantations. Although the yield would probably be small, the tax appears to be justifiable in principle.

In appraising the severity of taxes on business profits, it is important to take into account the adequacy of allowable deductions. The rise in prices during the war and postwar years has provoked a debate in India and in many other countries regarding the adequacy of depreciation allowances based on the original cost of plant and equipment. It is argued that when depreciation is based on historical cost, as is the rule in India, profits are overstated and the income tax makes it difficult for firms to finance replacement from internal funds. Some countries—for example, France and Belgium—have permitted a general revaluation of capital assets and a corresponding adjustment of depreciation allowances. Other countries, where there has also been a considerable rise in prices, have held fast to the original-cost principle.

This is a complicated issue that cannot be easily resolved. It is true that historical-cost depreciation allowances do not measure the current value of capital consumed in the process of production and are insufficient to finance replacement of assets acquired before the price rise. On the other hand, it must be recognized that the increase in prices of buildings and machinery is itself an indication that ownership of these assets has served as at least a partial hedge against inflation. A tax reduction for those who acquired

depreciable property when prices were lower than they now are would accentuate the advantage that this group already enjoys in comparison with holders of savings accounts, bonds, and other fixed money claims and recipients of inflexible salaries. From the point of view of maximizing public and private savings and capital formation, it seems desirable to link any tax adjustment directly to replacement or expansion. Unless accompanied by a requirement that the funds be reinvested, an increase in depreciation allowances on existing assets would permit larger distributions of profits, which would be used in part for additional consumption.

These considerations seem to indicate that the best approach is to allow liberal amortization provisions for new depreciable assets acquired either for replacement or expansion. This approach limits the tax concession and at the same time offers important assistance to firms wishing to modernize or expand. The "initial allowances" that have been granted in India and the United Kingdom are examples of this type of measure. Under this arrangement the taxpayer is permitted to deduct from taxable income a substantial percentage of the cost of a new asset immediately after its acquisition. In the United Kingdom the Tucker Committee on the Taxation of Trading Profits concluded that suitable initial allowances, but with total deductions limited to the actual cost of the asset, are the most appropriate form of tax adjustment for increased costs of capital assets[6].

3. **Betterment Levies and Service Charges**

Betterment levies and irrigation and power charges, as recognized by the Planning Commission, are among the most desirable means of capturing for the Government a part of the additional income directly attributable to the Five-Year Plan. Betterment levies are intended to absorb part of the "unearned increment" in the value of the land served by a new irrigation project. It seems reasonable that the state should appropriate part of the rise in value which reflects the expected additional agricultural yield attributable to the project. A betterment levy can be assessed at the inception of a project, but beneficiaries must be allowed to pay their assessments over a period of years as they actually experience an increase in income. The immediate effect of betterment levies in providing additional resources for development would not be large, but the resources would facilitate the maintenance or expansion of the development programme in the future.

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[6] *Report of the Committee on the Taxation of Trading Profits* (London April 1951, cmd. 8189), pp. 35-46.

The appropriate policy with respect to water rates, electric power charges, railway rates, and prices charged by other government enterprises is not always easy to determine. Although there are valid reasons for offering some services of public enterprises at prices below their full cost, the general policy should be to attempt to cover in the price all operating expenses and capital costs. Capital costs consist of interest on the investment and adequate depreciation allowances. Special justification should be required for departures from the policy of full-cost pricing.

Charges below full costs inevitably imply subsidies for users of the service which must be paid for by taxpayers. It is by no means clear that this combination of subsidies and taxes will necessarily improve the distribution of income or perform any other desirable function. Furthermore, the capacity of both the Central and State Governments to raise tax revenue is limited. If enterprises that could be self-supporting require a subsidy out of general revenues, other desirable public services will have to be curtailed because of inadequate financial resources. Finally, if the demand for the service is such that the full capacity of the enterprise would be used when charges cover all operating and capital costs, a lower charge is likely to result in an economically less efficient use of the service.

With respect to an established project, the question arises whether depreciation and interest allowances should be based on original outlays or on the cost of reproducing the facility. This is a matter of great importance in view of the permanent increase in the price level that has occurred since large investments were made in irrigation and power projects and the railways. It is implied in the considerations on which the general principle of full-cost pricing is based that the relevant costs are current costs of reproduction. If charges are based on original costs incurred when the price level was lower, the capital is in effect being consumed by users of the service. Inefficient use of the service may be encouraged, as in any other situation in which costs and returns are out of line. Even if waste could be minimized by effective rationing, there would remain a windfall gain for those who were fortunate enough to be served by a facility completed when prices were lower.

Betterment levies and full-cost irrigation and power charges are required, in most instances, to prevent an erratic and inequitable distribution of benefits and costs of public investment, as well as to promote economical use of the services. Appropriate levies and charges will not absorb the entire benefit of the projects to cultivators and power users. They will still enjoy a net gain, from

the more efficient use of their own labour, land, and capital; and the community will benefit from the greater production and the general rise in real incomes.

In some cases, however, exceptions to the principle of full-cost pricing are unavoidable. Other exceptions may be advisable as a matter of choice. Public authorities, like private investors, sometimes find, after they have sunk capital in an enterprise, that the services cannot be sold at a price that will cover all costs. If current operating expenses can be met, it will be less wasteful to operate the facility than to abandon it. A more difficult theoretical question is presented when it is possible to cover full costs but the price that will do so will so restrict the use of the service that the facility will operate at less than full capacity. Here two sets of considerations come into conflict. One is the truism that idle capacity is socially wasteful. The other is the inescapable fact that costs not covered by prices must be met out of general revenues, so that opportunities of providing other services will be restricted and the burden of providing public investment facilities shifted to taxpayers. The pragmatic approach is to relax the requirement of full-cost pricing only when there is strong reason for believing that it would result in a large unused capacity and when the government's budget position allows a subsidy to be provided.

A general re-examination should be made of charges for irrigation water, electric power, railway transportation, and other quasi-commercial services. In determining whether charges are adequate to cover full costs an allowance should be made for interest and depreciation on the basis of the present cost of replacing the plant and equipment. The Planning Commission has recommended that the States make fuller use of betterment levies and water charges. Some progress has been made, and the States have agreed to raise Rs. 295 million from new or increased betterment levies and irrigation rates over the period of the Plan. This seems a modest goal in view of the large amount to be expended on new irrigation works and the sharp rise in construction and equipment costs over the past decade or so.

4. Need for Positive Action

Two conclusions emerge clearly from this analysis. First, home resources even as estimated are not adequate for carrying out the Plan without resorting to measures that would risk serious inflation. Second, even the estimate of resources to be secured through home savings will not be realized unless positive action is taken to divert more of the expected increase in output into public or private savings.

It is hazardous to attempt to set quantitative standards for a country's capacity to save and to pay taxes. Nevertheless, it is evident that India can and should attack with renewed energy and ingenuity the problem of securing additional home resources for development. With greater effort it should be possible at least to approximate the goal set for public saving in the Five-Year Plan. It will be much harder to assure the projected level of private saving and investment or to expand public saving still further to make up for a deficiency in the private sphere. Even after every reasonable effort has been made, it is certain that available home resources will still fall short of the amount needed to proceed with the modest development programme, and to start the economy of India toward steady, if slow, progress in expanding production and attaining higher living standards

VIII. INTERNATIONAL PAYMENTS AND THE FIVE-YEAR PLAN

When there is a deficiency of real resources for development, it is not possible to determine how much of the deficiency is in the form of domestic resources (home produced goods) and how much is in the form of foreign resources (import goods). If the investment programme of the Five-Year Plan is undertaken without adequate resources, inflationary pressures will develop in the economy. It may be possible through price control and rationing to suppress for a time the manifestation of these pressures in the form of higher prices of essential goods. But the pressures of excess demand will remain and at one point or another they will break through. One of the points at which they are most likely to break through is in the international payments of India.

1. Exchange Resources and the Plan

When a country undertakes investment in excess of the real resources that are available, the inflationary pressure manifests itself in two forms: first, in some rise in domestic prices; second, in some increase in the balance of payments deficit. In India, an increase in incomes would be accompanied by a relatively large increase in the demand for food and a significant increase in the demand for cloth. These are export and import goods. A smaller part of the increase in incomes would be spent on purely home goods. For this reason, the balance of payments is likely to be the focal point of any inflationary pressures in India.

Although imports provide only a small portion of the supply of food grains, any increase in consumption would have to be met in the short run by imports. Domestic production cannot be quickly increased in response to demand, although it can be slowly increased by better irrigation facilities and improved methods of production. Almost the entire consumption of cloth is domestically produced, and an increase in demand would almost certainly be supplied from domestic sources. As the textile mills are not producing at full capacity, an increase in output is possible rather quickly. This would, however, require larger supplies of cotton which would have to be imported. In food and cloth, the two most important categories of consumer expenditure, the excess demand would be concentrated on imports in whole or in part and would give rise to a serious balance of payments deficit.

It would be possible to intensify import restrictions and thus hope to limit the balance of payments deficit. The inflation would then attack the export sector. If an increase in output of cloth, for example, is limited by the unavailability of larger supplies of imported cotton, domestic demand would absorb a larger part of textile output. To a greater or lesser extent, this would apply to other export goods, so that inflated home demand would operate to reduce the supplies available for export. As a practical matter, even the production of export goods would be affected by the inflation. As the excess demand is prevented from expressing itself in larger imports, it would be turned back to the domestic economy and would express itself in higher prices and higher costs. With higher domestic costs, world prices of export goods being unaffected, production would be less profitable and output would decline.

Even under the most favourable circumstances, with larger domestic resources than appear likely to be available, the payments of India may be subjected to heavy pressure in carrying out the Plan. Only with very severe restrictions on imports of consumer goods could India have enough foreign exchange to pay for the imported equipment contemplated in the Plan. And this requires the assumptions that export receipts will not be seriously affected by developments in India or in world markets, and that India will draw down its sterling balances to the extent foreseen by the Plan.

There is no reason why the sterling balances should not be used for development during the next three years in the amounts already agreed with the United Kingdom. It is important, nevertheless, to bear in mind that most of the remaining sterling balances are part of the essential foreign exchange reserves. With its large trade, India cannot reduce its reserves much beyond the level they are expected to reach by the end of the Five-Year Plan without weakening its capacity to deal with any future payments problems that may emerge.

The need to maintain and strengthen India's position in export markets is recognized in the Plan. If serious inflation is avoided in India, supplies for export will be forthcoming. This is one of the reasons why monetary policy must be directed to avoiding inflation. It may be that a deterioration in world markets will result in a fall in the price or the volume of India's exports. This is not a contingency that can be guarded against by India. The maintenance of adequate demand in world markets depends primarily on the policies of the great industrial countries. All that India can do is to hold enough reserves to deal with ordinary fluctuations in its payments position.

Even without inflation, the payments position would be weakened, and the capacity to carry out the Plan would be threatened, if there were a widespread crop failure in the next few years. Unless a grant or credit were available at the time, the extraordinary imports of food grains would involve such large sums that India would be unable to pay for the imports of equipment essential to the Five-Year Plan. In countries like India, where the crop is dependent upon the vagaries of the monsoon, sub-normal crops must be expected from time to time and a widespread failure of the crop may occur at any time. If the Five-Year Plan is not to be jeopardized by a crop failure, steps should be taken in the near future to assure India an adequate supply of food under such emergency conditions.

The world supply of wheat is adequate to meet any extraordinary future needs of India without affecting world market conditions—this is not the situation with respect to rice—it may be possible for India to make arrangements for an emergency supply of wheat that would meet the need for extraordinary imports of food grains in the event of a crop failure. If such arrangements could be made with the United States, Canada, and possibly Australia, it would give India assurance that the foreign exchange resources needed for the Five-Year Plan would not be drained away because of a bad crop. Ordinary imports of food grains would continue to be met by purchases out of current earnings.

2. **Foreign Aid and General Development**

The problem of resources for development in underdeveloped countries has two aspects : there is the payments aspect arising from the shortage of foreign exchange for the purchase of imported equipment; and there is the inflation aspect arising from the shortage of real resources because of the inadequacy of domestic savings. The poorer the country, the more likely it is that the difficulty of securing development with stability will arise from the inadequacy of total resources for investment rather than the lack of exchange for imported equipment.

Where the problem is one of inadequacy of resources, it cannot be met simply by providing foreign loans or grants to pay for imported equipment. And there is the danger that countries will distort their investment programmes to qualify for foreign aid available for imported equipment. Instead of giving priority to the most important projects, which may have a very small content of imported equipment, there will be a tendency to give priority to spectacular projects for which foreign aid is available because it has a larger content of imported equipment. Or, if the more important projects are given priority, they will be under-

taken in a manner that uses imported equipment wastefully where local labour and materials could be used more economically. If foreign aid is limited to loans or grants for imported equipment, it may act as an inducement to countries to resort to inflationary policies to finance development. Such a policy on foreign aid encourages the advocates of inflationary policies who argue that domestic resources are never lacking for development, that their provision is merely a matter of finance.

Countries should be encouraged to set up moderate development programmes suited to their practical needs. They should be encouraged to raise as much as is reasonably possible from taxes and domestic savings toward meeting the cost of their development programmes. A country giving foreign aid in the form of grants or loans might wish to limit the amount of such aid, either because of its own need for resources or because of the risks of the investment. And a country receiving foreign aid in the form of loans might wish to limit the amount it borrows because of the burden of repayment. In either case, the amount of aid given or received being determined, there is no reason for confining the aid to the purchase of imported capital equipment.

Another point that is often emphasized is that foreign investment should be so directed as to increase a country's exports or to decrease its imports. It is assumed that the investment will then act directly to strengthen the payments position by at least as much as the additional exchange requirements to service the investment. This is an erroneous view of the relation of foreign investment to the balance of payments. Even if all foreign investment went into the export-import field, it need not follow that the payments position would remain strong. For other investment would also be undertaken which might have the effect of increasing demand for import goods or have some effect on the domestic absorption of export goods. It is futile to earmark foreign investment for the export-import industries and domestic investment for purely home industries.

Every foreign investment, like every domestic investment, is consistent with a strong balance of payments, provided the investment, is in response to a market demand for the output and does not give rise to inflation. The only important principle for guiding the direction of investment is that it should be in industries for which the economy is suited. If there are profitable export markets for goods that can be produced in India, those are fields into which investment should go (with foreign or domestic capital). If there is a demand for import-type goods that can be produced profitably in India, those are fields into which investment should go (with foreign or domestic capital). It is a mistake to

assume, however, that the new investment must necessarily be in the production of export or import-type goods in order to increase exports or decrease imports. Price substitution can be as effective as technical substitution in displacing imports with home output or in releasing home goods for export. The essential point is that, if the new output can be sold at prices that will create demand, such price substitution for import-export goods will take place.

If there is a reasonable degree of price flexibility and if wage rates are related to productivity in the export-import industries, an appropriate monetary and exchange policy can maintain a level of aggregate demand suited to full employment without inflation and at the same time assure over-all balance in foreign payments. If there is inflation, however, home demand will absorb the whole value of the additional output, leaving no surplus to service the foreign debt, irrespective of the sector in which the original investment was made.

3. Foreign Resources for Development

Clearly, foreign resources can contribute materially to a sound development programme. The amount of such resources is not determined by the volume of investment that it would be appropriate to make in export-import industries; nor should foreign resources necessarily be limited to paying for imports of capital equipment.

The amount of additional resources that a country needs to carry out a development programme can be properly stated in only one way. Given the levels of income, expenditure, and savings, and the pattern of production, consumption, and investment, then the deficiency of resources is the excess of the cost of investment over the amount of domestic savings (and foreign investment). This deficiency will manifest itself in the excess of demand for particular goods over the supply of the same goods produced at home or imported without incurring an unwanted deficit in the balance of payments. The goods that cannot be produced at home or that cannot be paid for if imported are the real resources the country needs to carry out the development programme without inflation.

What these goods will be depends upon the pattern of consumers' expenditure and the nature of the investment projects in the development programme. In India, a very large proportion of the increase in incomes in the initial stages of the development programme would be spent on food grains. It has been estimated that as much as 40 to 50 per cent of the average increase in income would be spent on food grains, largely on wheat and rice.

As larger supplies of rice may not be readily available, much of this increased expenditure would be on wheat, particularly if a larger rice-wheat price differential develops. Another significant part of the increase in incomes would be spent on cloth. As textile capacity is available, the actual deficiency is one of cotton rather than of cloth. Deficiencies are also likely to appear for miscellaneous consumer goods, perhaps for other raw materials, and, of course, for capital equipment. All these goods could be imported from abroad.

Undoubtedly, the increased demand arising from a rise in incomes would also be directed to other goods distinctively domestic in character. In the later stages of the development programme, when production responds to new investment, output of such goods will be increased; in the initial stages of the development programme, however, the increase in output might fall short of the increase in demand. This deficiency of resources can be made good by imports. Presumably, with a very small rise in the prices of such goods, demand can be induced to shift to other goods whose supply can be more fully expanded through imports. All this indicates that foreign resources could provide an appropriate substitute for domestic resources in carrying out the Five-Year Plan in India.

The Mission has studied the data provided by the Planning Commission. It could not, however, make independent estimates of its own, either of the resources needed for the Five-Year Plan or of the resources available for the Five-Year Plan. The aggregate investment that needs to be financed (investment apart from the labour of small proprietors) is certainly not less than the amount set forth in the Plan. The estimate of resources set forth in the Plan is probably in excess of the amount that can be realized on the basis of present policies. It should be possible, however, to increase the domestic resources for the development programme by policies designed to increase tax revenues and savings and to divert investment from less productive to more productive uses. Even with the most forceful measures, however, there is likely to be a large deficiency of resources for the Five-Year Plan. If investment is curtailed, the deficiency of resources may not be apparent; nevertheless, it will be real and will hamper economic progress.

4. **Foreign Aid and Future Payments**

The Government of India is now receiving aid for its development from several countries. The United States, the United

Kingdom, Canada, Australia, New Zealand, and Norway, among others, have provided aid in one form or another. The Five-Year Plan is so essential to the well-being of the people of India that it should be possible to find an agreed basis for additional foreign aid to India. To the extent that such aid is available on a grant basis, the strain on the Indian economy will be reduced. Income levels are so low and domestic savings so limited that repayment of credits would necessarily slow down the rate at which consumption standards can rise and development be accelerated in the future.

In any case, India must go forward with its development with the aid of whatever foreign capital it can obtain. It would be a mistake to exaggerate the burden of servicing foreign obligations incurred for development. The payment of interest and amortization of principal would require the Indian economy to set aside part of its future output and part of its future foreign exchange receipts for these purposes. On the other hand, development with foreign capital will increase the output of the Indian economy by much more than the cost of servicing the debt. If the development is suited to the economy, this increase in output will result in an improvement in India's payments position sufficient to provide for growing import needs as well as service requirements on the foreign debt.

The payments position of India on foreign investment account is now much stronger than before the war (see Table 17). In the fiscal year 1938-39, the net transfer of investment income abroad from undivided India amounted to Rs. 270 million, and amortization and other contractual payments accounted for a net payment abroad of another Rs. 105 million. These two items together amounted to one fifth of the total export proceeds of India in 1938-39. In the calendar year 1951 the net transfer of investment income was roughly Rs. 240 million and amortization and contractual payments only Rs. 8 million—together amounting to only 3·5 per cent of the export proceeds in that year. The situation was actually better in 1952. It is clear that net payments on foreign investment account represent a much smaller real burden than in prewar years. The conclusion is reinforced if another item in the balance of payments is taken into account. The 1938-39 balance of payments included net transfers of Rs. 140 million on Government of India account not included elsewhere. An unknown portion of this represented interest payments, and thus constituted payment abroad on foreign investment account. In recent years, transfers on Government of India account not included elsewhere have actually resulted in sizeable net receipts.

TABLE 17.—*India's Payments on Foreign Investment Account, Compared with Receipts from Exports*

(In millions of rupees)

	1938-39	1949	1950	1951	1952
1. Payments for investment income . .	271	179	236	239	104
2. Amortization and other contractual payments	105	..	4	8	37
3. Total investment payments (1+2) . .	376	179	240	247	141
4. Receipts from exports, f.o.b. . . .	1,858	4,260	5,561	7,046	6,128
5. Total investment payments as per cent of receipts from exports	20	4·2	4·3	3·5	2·3

Source : International Monetary Fund, *Balance of Payments Yearbook*, 1938, 1946, 1947, p. 214, and *International Financial Statistics*, June 1953, p. iii.

The great change in the foreign investment account reflects, in the main, the reduction in India's gross foreign indebtedness during the war. In the late 1930's British investment in railways and official securities (i.e., excluding British investment in the private sector) was estimated at about £400 million. Apart from this, the Government of India was obligated for large pension payments to retired members of the Indian Civil Service resident abroad. These payments comprised a significant part of the transfers of the Government of India to England. For practical purposes they represented a fixed obligation not unlike a foreign debt.

The situation changed very sharply during the war. Large sterling assets were accumulated and part of these funds were used to repatriate official securities held abroad. Arrangements were also made to capitalize India's obligation on pensions to retired members of the Indian Civil Service residing in England. There was also some liquidation of private British investment in India in the early postwar years. This investment has been resumed in recent years and there has also been some increase in the market value of the old investment. Comparable estimates of private foreign investment, prewar and postwar, are not available. However, the census taken by the Reserve Bank of India shows that the book value of all foreign direct and portfolio investment in India was approximately Rs. 3·2 billion in 1948 (excluding miscellaneous short-term balances), probably a lower

figure in rupee value than the comparable prewar private foreign investment.

Apart from the change in total foreign investment, the composition of foreign investment in India now includes a larger proportion of direct and a smaller proportion of fixed interest obligations than before the war. Income transfers abroad pertaining to direct investments tend to fluctuate with foreign exchange receipts. Thus in 1951, when prices were high and export receipts were over Rs. 7 billion, net transfers of investment income amounted to Rs. 239 million; in 1952, after prices fell and when export receipts were Rs. 6·1 billion, net transfers of investment income amounted to only Rs. 104 million.

While India's official sterling debt has been practically wiped out, the Government of India has incurred new obligations in dollars. A debt of $190 million was incurred to the Government of the United States on the wheat loan. Within two years India will owe the International Bank about $100 million for loans already made which will in due course be spent on development projects. About $10 million is owed to the Government of Canada. The postwar dollar debt incurred by the Government of India is thus about $300 million, exclusive of an obligation of $100 million to the International Monetary Fund. Even so, the over-all position on official foreign indebtedness is enormously improved. In rupees, the dollar debt represents about one fourth of the prewar official sterling debt; in dollars, it represents about one sixth of the prewar official sterling debt; and in real terms, it represents about one twelfth of the prewar official sterling debt.

Perhaps no factor is weighted more heavily by U.S. investors in the determination of the credit worthiness of a country than the country's dollar payments position. Before the war, India was generally a dollar surplus country. In the postwar period, India has been a dollar deficit country, except in 1950. It is quite possible for India to revert to its prewar position as a dollar surplus country. That will depend on three factors: the maintenance of a strong over-all balance of payments; the availability of import supplies from non-dollar countries; and the expansion of dollar exports by India. The overall payments position of India is very largely a matter of monetary policy. The availability of import supplies, particularly food, from non-dollar countries is beyond India's control, except as it can develop its own agriculture. The expansion of dollar exports may be expected as part of the general development programme of India.

If India could meet its prewar obligations on foreign investment without any great strain on its balance of payments, it should

be able to meet future obligations, resulting from any new debts, provided its balance of payments position in the future is not materially worse than in the past. There is nothing in its financial history that would for a moment suggest that the Government of India would default on a foreign obligation because of adversity in its payments position. Furthermore, the Government has shown in the past three years that it is capable of taking financial measures to put its payments in order. Given a liberal trade policy, the resumption of the natural trade relations of the subcontinent, and the development of India's productive capacity, there is every reason for expecting that the payments position of India will be stronger in the future than it has been in the past.

GIPD—SS—296 MofFin—30 1-54—2,000